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No. 74-124

In The
Supreme Court of the United States

October Term, 1974

Blue Chip Stamps, et al.,

Petitioners,

v.

Manor Drug Stores, On Behalf of Itself and All Other Users of Blue Chip Stamps Who Were Entitled But Failed to Purchase Stock of Blue Chip Stamps.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONERS

OPINIONS BELOW

The majority and dissenting opinions of the court of appeals are set forth in the separate appendix at App. 133 through 153. The order of the court of appeals denying the petitions for a rehearing *in banc* and modifying the majority and dissenting opinions is set forth at App. 154 through 156. The opinions of the panel, as modified, are reported in 492 F.2d at 136. The opinion and order of the district court, reported in 339 F. Supp. at 35, is set forth at App. 123 through 131.

JURISDICTION

On October 15, 1973, a panel of the court of appeals entered its decision reversing the district court's dismissal of the amended complaint. The matter was ordered remanded for further proceedings. (App. at 142.) On October 26, 1973, a judge of the court of appeals extended the time for petitioning for a rehearing *in banc* and ordered the mandate stayed. Timely petitions for a rehearing *in banc* were then filed. On April 1, 1974, an order was entered denying the petitions and making minor changes in the panel's opinions. Five active circuit judges noted that they would have granted a rehearing *in banc*. (App. at 154-56.) On June 21 Mr. Justice Douglas extended the time for filing a petition for certiorari to and including August 15, 1974. The petition was filed on August 15 and the writ granted on November 11, 1974. The Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. Can a person who has never owned, purchased or sold securities bring an action under section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 of the Securities and Exchange Commission for damages allegedly occasioned by his failure to purchase securities offered him?

2. Does permitting a suit for damages to be brought under section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 of the Securities and Exchange Commission by a person who allegedly declined to purchase offered securities because of an unduly pessimistic prospectus irreconcilably conflict with the purposes of the Securities Act of 1933?

3. Can a person who is not a party to a federal antitrust consent decree assert in a separate action rights alleged to derive from that decree?

STATUTORY PROVISIONS INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), provides in pertinent part:

> "§ 78j. Manipulative and deceptive devices.
>
> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —
>
> ". . . .
>
> "(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated by the Securities and Exchange Commission, provides as follows:

> "§ 240.10b-5 Employment of manipulative and deceptive devices.
>
> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k, is set forth in pertinent part as Appendix A to this brief at Br. App. (1) through (5).

STATEMENT OF THE CASE

Petitioners are Blue Chip Stamps, Blue Chip Stamp Company, and various corporations and individuals who were, respectively, shareholders and directors of Blue Chip Stamps.[1] Respondent Manor Drug Stores, and the members of the proposed class it seeks to represent, were users of Blue Chip's trading stamp service who were offered, but did not purchase, stock and debentures of Blue Chip Stamps. Respondent brought an action against petitioners for damages allegedly suffered by

[1] Petitioners, named defendants in this action, are Blue Chip Stamps, Blue Chip Stamp Company, Alexander's Markets, Lucky Stores, Inc., Market Basket, Purity Stores, Inc., Ralphs Grocery Company, Safeway Stores, Inc., Thriftimart, Inc., Thrifty Drug Stores Co., Inc., Vons Grocery Co., Robert E. Alexander, Donald A. Koeppel, Leonard H. Straus, William F. Ramsey, Robert E. Laverty, Richard Ralphs, John R. Niven and Fred Von der Ahe.

respondent and the members of the proposed class as a result of their failure to purchase the offered securities, which failure to buy was purportedly caused by an unduly negative prospectus.

The decision under review is a 2-1 ruling by a panel of the United States Court of Appeals for the Ninth Circuit. The panel majority reversed an order of the United States District Court for the Central District of California dismissing respondent's amended class action complaint for failure to state a claim upon which relief could be granted. The district court ruled that respondent lacked standing to assert rights allegedly created by an antitrust consent decree to which it was not a party. The district court also ruled that the respondent was not entitled to maintain an action under section 12 of the Securities Act of 1933, and under section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 of the Securities and Exchange Commission, for damages allegedly occasioned by its failure to purchase the offered securities.

1. Allegations of the Amended Complaint.

Because the district court decided the matter on motions to dismiss, this brief assumes the truth of the material well pleaded averments of the amended complaint and its supporting exhibits, which are incorporated into the complaint by reference.[2] The facts there set forth are as follows:[3]

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[2] A motion to dismiss takes as true only material well pleaded allegations of the complaint; it does not take as true opinions or conclusions of the pleader, including opinions and conclusions regarding the construction or effect of operative documents annexed to the complaint. *E.g.*, *Equitable Life Assurance Soc. v. Brown*, 213 U.S. 25, 42-43 (1909); *Nortz v. United States*, 294 U.S. 317, 324-25 (1935); *Zeligson v. Hartman-Blair*, 126 F.2d 595, 597 (10th Cir. 1942); 2A MOORE'S FEDERAL PRAC-

In 1963 the government filed a civil antitrust action under the Sherman Act against Blue Chip Stamp Company and nine of its corporate shareholders. (App. at 8, 23.) In June of 1967 the action terminated with the entry of a consent decree. (App. at 8, 23-35.)[4] In accordance with one of the provisions of that decree defendants submitted to the antitrust court a plan for the reorganization of Blue Chip Stamp Company. (App. at 8-9, 40-51.) The plan was ultimately approved. (App. at 8, 36-39.)[5]

The reorganization plan provided, *inter alia,* for the reduction of the amount of Blue Chip stock owned by the shareholder defendants in the antitrust action. (App. at 10, 38.) It called for the organization of a new corporation, Blue Chip Stamps ("new Blue Chip"). (App. at 41-42.) Then Blue Chip Stamp Company ("old Blue Chip") was to be merged into new Blue Chip and a total of 621,600 shares of new Blue Chip common stock were to be issued to the stockholders of old Blue Chip. (App. at 40-43.) To reduce the holdings of the defendant stockholders in new Blue Chip the plan provided for an offering by new Blue Chip of another 621,600 unissued shares to users of old Blue Chip's trading stamp service, a smaller offering to Blue Chip's management, and the grant of stock options to key employees. (App. at 44-48.)

TICE ¶ 12.08 at 2265-69 (2d ed. 1974). The complaint makes statements regarding the exhibits to the complaint which are contradicted by those documents. Where these conflicts are relevant to a decision of the issues under review, this fact statement relies on the documents themselves.

[3] The amended complaint and its exhibits are set forth in the separate appendix at App. 4 through 122.

[4] The June 5, 1967, consent decree was Exhibit A to the amended complaint and is reprinted in the separate appendix at App. 23 through 35.

[5] The plan of reorganization and the order approving it formed part of Exhibit B to the amended complaint and are reprinted in the separate appendix at App. 36 through 51.

The 621,600 shares to be offered to users of old Blue Chip's trading stamp service were not to be sold alone: They were to be part of a package, or "unit", and the number offered to each user was to be proportional to past stamp usage. (App. at 6, 44-47.) Each unit consisted of a $100 principal amount 6½% subordinated debenture maturing in 1978, and three shares of common stock. (App. at 9, 41, 44-45.) The offering price of a unit was to be $101. (App. at 9, 41.) The new Blue Chip debentures were subordinated to certain senior indebtedness and to various categories of existing and future legal claims and causes of action, including claims and actions against old Blue Chip, new Blue Chip or their officers, directors or shareholders, based on violations of the antitrust laws or arising out of the reorganization. (App. at 44-45, 80-81.)

In 1968 new Blue Chip was organized and made the offering to users described in the reorganization plan. (App. at 11-12.) More than half of the units were sold. (App. at 12.) Respondent and the users it purports to represent could have purchased a portion of the units in the offering, but did not do so. (App. at 18.)[6]

Two years after the offering, on November 10, 1970, this case was initiated by a complaint filed in the United

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[6] Neither the plan nor the antitrust court's order provided that "[a]ny of the 621,600 shares not purchased by the non-stockholding users were to be sold on the open market," as the court of appeals' opinion erroneously states (App. at 136), and as the amended complaint alleges. (App. at 9-10.) For the provisions of the order and plan respecting unsold shares, see App. at 38, 49.

The order approving the plan did provide that all the shares distributed in connection with the reorganization were to be freely alienable, and it contemplated that the shareholder defendants might sell some or all of their shares. (App. at 37-38.) A large number of the shares received by the shareholder defendants were sold in 1969. *See* p. 9, *infra*.

States District Court for the Central District of California but never served. (App. at 1, R. 1-17.) The amended complaint and the exhibits thereto, filed January 27, 1971, and later served, set forth the foregoing facts. The amended complaint contends that respondent and the members of the alleged class have suffered injury by reason of their failure to purchase the offered units, and seeks damages.

Although the amended complaint contains four "causes," respondent seeks recovery under essentially two theories. The first theory is found in causes one, two and three. These purport to state claims for relief under section 12 of the Securities Act of 1933, 15 U.S.C. § 77*l*, section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5.

In claim one, respondent avers that "several" nonstockholder users of old Blue Chip's trading stamp service "appear[ed]" before the antitrust court and contended that they "owned an interest in" old Blue Chip and profits it had accumulated and that in any decision of the government action the users' ownership of an interest in Blue Chip "should be decreed." (App. at 10.) These contentions allegedly "prompted" the provisions of the reorganization plan providing for an offering to users, and that offering allegedly was intended to be and was in fact a bargain designed to "benefit" the non-shareholder users. (App. at 10-11.) Respondent avers that "[t]he reasonable market value" of the units was and is "at least" $315.00, of which $75.00 represents one subordinated debenture and $80.00 represents each share of stock. Accordingly, "[t]he net bargain provided by said offering was . . . approximately $71.33 per share or $214.00 per unit." (App. at 11.)

Respondent alleges that old Blue Chip, new Blue Chip and the stockholders and directors named in the amended complaint desired that respondent and the members of the class it purports to represent not "exercise their rights" under the consent decree and plan "to purchase the shares to which they were entitled." (App. at 13.) In furtherance of this desire, petitioners allegedly caused the preparation of a conservative — or "negative" — prospectus[7] which disparaged the value of units. (App. at 13-17.)

Specifically, respondent complains that on the second page of the prospectus there was set forth, under the heading "Items of Special Interest", an index and summary of items of a negative nature which were discussed in full elsewhere in the prospectus. (App. at 13-15, 56.) When some of the petitioners sold their own shares[8] in a secondary offering over a year later (without combining them with subordinated debentures), no such list of items was included in the new prospectus.[9] (App at 15.)[10] Re-

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[7] The August 29, 1968, prospectus was Exhibit C to the amended complaint and is reprinted in the separate appendix at App. 55 through 90.

[8] An examination of the complaint and the supporting documents shows the court of appeals to have erred in suggesting that the shares later sold may have been the same shares offered in 1968 as part of the units. (App. at 137 n.7.) The shares offered in 1969 were owned by the selling shareholders themselves, not Blue Chip Stamps. (App. at 15, 100-01, 108.)

[9] The November 10, 1969, preliminary prospectus for the secondary offering was Exhibit D to the amended complaint and is printed in the separate appendix at App. 91 through 122.

[10] The statement in the court of appeals' opinion that the second prospectus "made no reference" to the items on this list is incorrect. (App. at 137.) A comparison of the allegations of the complaint with the factual recitations in the two prospectuses shows that respondent alleges the *list* was absent in the second prospectus, not that the items listed went unmentioned. (App. at 15, 56, 91-122.) They were, in fact, discussed in the second prospectus, although that discussion reflected sub-

spondent further complains that the discussion in the first prospectus of the various matters referred to in the list was unduly negative in that it called undue attention to the payment of some $7.9 million in settlement of legal claims and causes of action during the preceding six months, and the pendency of an additional $29 million in claims and causes of action (to which the debentures were subordinated); to the consent decree's prohibition against service by old Blue Chip directors on new Blue Chip's board; to the decree's requirement that Blue Chip offer for sale one-third of its trading stamp business in California; and to actual and possible loss of patronage by users and the fact that Blue Chip had no assurance of continued patronage. (App. at 14.) It is also alleged that the prospectus overestimated the percentage of Blue Chip's stamps that would ultimately be redeemed, and that this resulted in an understatement of earnings on stamp sales. (App. at 16-17.)[11]

Respondent contends that it and the members of the class it purports to represent did not buy any units because they were defrauded through the use of the first prospectus. (App. at 18.) Respondent seeks to recover as damages the difference between the $101 offering price of the unpurchased units and the alleged "reasonable market value" of $315. This $214 per unit totals $21.4 million in damages for respondent's alleged class. (App. at 12, 18.) Also sought are the right to buy the offered but unsold units at the 1968 offering price, attorneys' fees, interest, and $25 million in punitive damages. (App. at 22.)

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sequent events and the fact that the second offering did not involve debentures subordinated to antitrust and other claims. (App. at 96-99, 100-02, 103-04, 108-09.)

[11] If the first prospectus were inaccurate in this regard, so then was the second prospectus: They both used the same estimated redemption rate of 97.5%. (App. at 66, 99.)

The amended complaint's second and third causes reassert the averments of the first cause. In the second cause, respondent makes the additional allegation that petitioners acted with actual fraudulent intent. (App. at 19.) In the third cause, respondent contends merely that the petitioners lacked a "sufficient or reasonable" grounds for believing the "false and misleading representations" in the prospectus to be true. (App. at 20.)

Respondent's second theory of liability is found in the amended complaint's fourth cause, a pendent claim. It reasserts the averments of the first cause and adds the allegation that respondent and the class it purports to represent were "the express intended beneficiaries of said final consent judgment entered into between the [United States] and [the defendants in the antitrust action] . . .", that the consent judgment "stated that defendants planned a reorganization of [old Blue Chip]", that the reorganization was to be conducted in good faith, and that the petitioners' alleged misrepresentations were "a violation of the Court imposed duty of good faith and constituted a breach of said Final Consent Judgment." (App. at 21.) Cause four seeks the same relief as causes one, two and three. (App. at 21.)

2. Decision of the District Court.

The district court granted petitioners' motions for an order dismissing the amended complaint with prejudice for failure to state a claim upon which relief could be granted. With respect to the fourth cause, the court ruled that respondent, who had not been a party to the government antitrust suit and consent decree,[12] lacked standing

[12]The non-shareholder users of old Blue Chip's stamp service were not parties to the antitrust action. Several non-parties did appear before the antitrust court as *amici curiae*. Attempts by some users and others to intervene after entry of the

to sue for breach of the terms of the antitrust court's judgment or to assert rights alleged to derive from that decree. (App. at 125-27.)

As for the first three causes, the district court held that the statutes and rule relied upon by respondent did not give it a cause of action. Section 12 of the Securities Act of 1933 expressly limits recovery to "purchasers" of securities, something which respondent claims not to be. (App. at 127.) And, the court stated, under section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 a party may sue for damages only if it has entered into a transaction "having the effect of a purchase or sale of securities." (App. at 130.) Since respondent did not enter into any such transaction, it could not state a claim. (App. at 127-30.)

3. Decision of the Court of Appeals.

Respondent appealed to the United States Court of Appeals for the Ninth Circuit on all aspects of the district court's ruling. (App. at 132.) The matter was briefed, argued and, on March 2, 1972, submitted to a panel consisting of Judges Browning, Hufstedler and Choy. On March 17 the panel vacated the submission and requested that the SEC file a brief as an *amicus curiae*. The SEC submitted a brief, advocating complete abandonment of the rule founded upon the decision in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). As it has developed, the so-called "*Birnbaum* rule" provides that a private litigant may sue for damages under rule 10b-5 only if he can be considered to have been a purchaser or seller

consent decree for the purpose of having the decree vacated were denied. *United States v. Blue Chip Stamp Co.*, 272 F. Supp. 432 (C.D. Cal. 1967), *aff'd sub nom. Thrifty Shoppers Scrip Co. v. United States*, 389 U.S. 580 (1968).

of securities. Both petitioners and respondent filed briefs directed to the SEC's arguments, and the matter was resubmitted.

On July 20, 1972, the panel requested that the parties and the SEC file memoranda directed to the effect on this case of the unanimous decision by another panel of the circuit in *Mount Clemens Industries, Inc. v. Bell,* 464 F.2d 339 (9th Cir. 1972) (Chambers, Koelsch and Ely, JJ.). That decision adopted the *Birnbaum* rule in the Ninth Circuit and denied permission to sue to a non-purchasing, non-selling non-investor. The parties and the SEC filed memoranda and the matter stood submitted in the fall of 1972.

The panel handed down its decision on October 15, 1973. Judge Browning, writing for himself and Judge Choy, reversed the district court and remanded the matter for further proceedings.

In finding that the respondent had standing to sue for damages the majority reasoned as follows: The purpose of section 10(b) of the 1934 Act and rule 10b-5 is to protect the purity of stock transactions against manipulative and deceptive practices such as are alleged by respondent, and it is irrelevant to this purpose that a purchase or sale never actually occurred. Under the allegations in the complaint, the court concluded, injunctive relief would have been available if timely sought by the SEC or a party with sufficient interest. Since a violation of the rule was alleged, should respondent be barred from suing for damages solely because it did not purchase? The majority answered this question in the negative.

The requirement that a plaintiff in a damage action be a purchaser or seller, the majority asserted, rests on

considerations other than whether the conduct alleged was within the scope of the statute's and the rule's purpose; it rests on the assumption that unless a plaintiff alleges that he purchased or sold the stock involved in the fraud, his chances of proving his case are too slight to allow the action to proceed. (App. at 138-40.) This assumption is usually justified because of the lack of objective evidence regarding causation and damages. (App. at 140-41.) However, the majority noted that plaintiffs who have been parties to a contract to purchase or sell securities have been allowed to sue for damages, notwithstanding the absence of a consummated purchase or sale. It concluded that even though respondent could not have enforced the consent decree, if the allegations of the complaint concerning the decree and its intentions are taken as true, the decree "serves the same function" as a contract to purchase.[13] It increases the respondent's apparent ability to prove its causation and damage claims sufficiently to satisfy what the majority saw as the purpose of the purchaser-seller requirement. (App. at 141-42.)[14]

Judge Hufstedler, in dissent, said the majority's ruling misconceives the policy underlying the purchaser-seller

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[13] The majority opinion as originally written used the phrase "served as the functional equivalent" of a contract to purchase. (App. at 141.) However, the order denying rehearing *in banc* altered this phrase to "serves the same function as". (App. at 154-55.) This change in wording appears to be without substantive significance.

[14] The ruling of the district court with respect to respondent's claims under section 12 of the 1933 Act, which the court of appeals did not mention, was correct. The civil liability provisions of section 12 *expressly* limit those who can bring actions for damages to actual purchasers. Thus, no right of action is created in favor of one, such as respondent, who alleges only that it did not purchase securities. *Greater Iowa Corp. v. McLendon*, 378 F.2d 783, 790 (8th Cir. 1967) (Opinion of Gibson, J., joined by Blackmun and Mehaffy, JJ.)

doctrine. (App. at 146-48, 149-53.) Further, she observed that unless the majority rejects the established rule denying non-parties to antitrust consent decrees standing to sue on those decrees, the decree in no way sets the users apart from any other person who is offered but does not purchase securities. (App. at 145-46 & n.3, 148-49.) Thus, the majority's decision amounts to a rejection of the purchaser-seller rule in any case where a plaintiff can plausibly allege causation and damages. (App. at 146-47 n.4.) This result, she noted, invites damage actions brought by non-participants in the market who simply watch from the sidelines and risk nothing, and it places an almost impossible burden on prospectus draftsmen. (App. at 152-53.)

On November 5, 1973, petitioners sought a rehearing *in banc*. Respondent and the SEC filed briefs opposing the petition; on April 1, 1974, it was denied. Judges Koelsch, Ely, Hufstedler, Trask and Wallace noted their votes to rehear the case *in banc*. The order denying the rehearing also made minor changes in the opinion of the panel majority and in the dissent. (App. at 154-56.)

This Court granted certiorari on November 11, 1974.

SUMMARY OF ARGUMENT

For at least two reasons the decision of the court of appeals is erroneous.

First, it rejects the long-standing rule that a private plaintiff seeking damages for a violation of section 10(b) of the Securities Exchange Act of 1934 and SEC rule 10b-5 must be a purchaser or seller of securities. This purchaser-seller rule has been developed to give definition to the judicially implied private right of action under 10b-5 and represents sound policy. The reasoning of the

court of appeals throws over that rule and would permit any non-purchasing, non-investor offeree to state a claim under 10b-5 for the recovery of the difference between the price at which he was offered, but declined to buy, securities and the amount the securities subsequently appear to have been worth at the time of the offer.

Granting a right of action to a non-purchasing, non-investor offeree cannot be justified when the benefits to be gained are weighed against the effects of the almost limitless resulting liability and the tremendous potential for abuse. And where, as here, the complaint charges that the offer in question was made *via* a prospectus required by the Securities Act of 1933, and that the prospectus was too pessimistic because it emphasized adverse contingencies to which the company and the securities were subject, permitting a non-purchasing offeree to seek damages for his lost "bargain" undercuts the 1933 Act's policy of requiring full disclosure of all adverse facts and contingencies to potential investors. Adherence to the purchaser-seller rule in this circumstance prevents a direct conflict between the implied right of action under rule 10b-5 and express provisions of the Securities Act of 1933.

Second, the court of appeals erred to the extent it attempted to limit its decision to the facts of this case by relying on the amended complaint's allegations that the respondent and its alleged class were intended beneficiaries of the antitrust consent decree. The respondent and the other non-shareholder users of Blue Chip's trading stamp service were not parties to that decree and are not express beneficiaries under the terms of either the decree or the plan of reorganization. But even if these non-parties are permitted to show that the antitrust court *intended* to benefit them, that would not serve to distinguish them from all other non-purchasing offerees for

the purposes of determining their right to bring an action under rule 10b-5. The established rule is that non-parties to a consent decree cannot, even if they are express beneficiaries of the decree, derive any rights from that decree and cannot sue, directly or indirectly, to enforce the decree. To distinguish respondent, because of its claim to be a beneficiary of the decree, from other non-purchasing offerees attempting to sue under rule 10b-5 for the benefit of some lost bargain is completely inconsistent with and will frustrate the strong policy considerations that underlie the Department of Justice's program for ending most antitrust actions through consent judgments.

In both the foregoing respects the court of appeals departed from established authority and reached a result that cannot be supported by sound policy. For these reasons, petitioners ask that the decision below be reversed.

ARGUMENT

I.

IN BARRING A NON-PURCHASING, NON-INVESTOR OFFEREE FROM ASSERTING A CLAIM FOR DAMAGES THE *BIRNBAUM* DOCTRINE PROPERLY DELINEATES THE IMPLIED PRIVATE RIGHT OF ACTION UNDER RULE 10b-5 AND SERVES TO PREVENT A DIRECT CONFLICT WITH THE EXPRESS POLICY OF THE SECURITIES ACT OF 1933.

A. The purchaser-seller rule as it has been developed denies standing to seek damages to a non-purchasing, non-investor offeree.

Section 10(b) of the 1934 Act and rule 10b-5 do not expressly provide a private civil right of action for harm

suffered as a result of conduct prohibited by the section and rule. The courts, however, have long implied such a cause of action. *E.g., Fischman v. Raytheon Mfg. Co.,* 188 F.2d 783 (2d Cir. 1951); *Kardon v. National Gypsum Co.,* 69 F. Supp. 512 (E.D. Pa. 1946). And this Court has recognized the existence of an implied right of action for damages. *Superintendent of Insurance v. Bankers Life & Casualty Co.,* 404 U.S. 6, 13 n.9 (1971); *Affiliated Ute Citizens v. United States,* 406 U.S. 128, 150-54 (1972).

Because section 10(b) and rule 10b-5 do not provide for private civil liability, they do not set forth the "elements" of the cause of action, nor do they clearly designate the persons who are entitled to assert that cause, or describe the circumstances under which various remedies may be available. For these reasons, and because of the sweeping language of 10(b) and 10b-5, the courts have developed various doctrines to define the 10b-5 cause of action. Principal among these is the purchaser-seller rule.

In determining what class of persons should be permitted to bring an action for damages under section 10(b) and rule 10b-5 the legislative history of the section has provided little assistance to the courts. What history there is indicates that section 10(b) was viewed simply as a residual antifraud provision. There is no indication that Congress thought it was creating a private civil right of action under the section. *See* 1 A. Bromberg, Securities Law § 2.2 at (300)-(340) (1973); Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?* 57 Nw. U.L. Rev. 627, 642-60 (1963).

However, rule 10b-5 does have some administrative history. It was promulgated in 1942 under authority of section 10(b). Its language is almost entirely derived from section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a). In promulgating the rule the SEC did not con-

template that it would play a role in private actions. 10b-5 had a rather narrow purpose of closing a loophole in the various antifraud provisions the SEC administered by extending prohibitions on fraud to all purchasers of securities. *Birnbaum v. Newport Steel Corp., supra,* 193 F.2d at 463; 3 L. Loss, SECURITIES REGULATION at 1469 & n.87 (1961); 6 L. Loss, *supra,* at 3617 (Supp. 1969); 1 A. BROMBERG, *supra,* § 2.2 at (410)-(420).

During the initial stages of the judicial evolution of private civil liability under rule 10b-5, *Birnbaum v. Newport Steel Corp.,* 193 F.2d 461 (2d Cir. 1952), was decided. The Second Circuit refused to permit non-purchasing, non-selling shareholders complaining of a breach of fiduciary duty by corporate insiders to sue for damages under section 10(b) and rule 10b-5. It reasoned that the section and rule were not intended to reach breaches by corporate officers of their fiduciary duties, but only to prohibit that type of fraudulent conduct usually associated with purchases and sales of securities. And the declared purpose of the SEC in promulgating the rule was the narrow one of extending prohibitions previously limited to broker-dealers. Therefore, the court concluded, 10b-5 "extended protection only to the defrauded purchaser or seller." 193 F.2d at 464. Since the plaintiffs did not fall within either category, they were denied standing to sue.[15]

Although the somewhat narrow reading *Birnbaum* gave to the type of conduct reached by the rule has been abandoned, *see* Note, *The Controlling Influence Standard*

[15]The term "standing" has been used repeatedly to describe whether one may maintain a private action under 10b-5 for damages. This use of the term does not refer to Article III "case or controversy" standing, but to the more general concept of who should be entitled to bring an action for a specific type of relief and have his claim adjudicated on the merits. *See SEC v. National Securities, Inc.,* 393 U.S. 453, 467 n.9 (1969).

in Rule 10b-5 Corporate Mismanagement Cases, 86 HARV. L. REV. 1007, 1016-20 (1973), the decision's "purchaser-seller" rule has been followed over the intervening 22 years. The Second Circuit has repeatedly reaffirmed that one may not bring an action for damages allegedly occasioned by a violation of 10b-5 unless he is a purchaser or seller of securities. *E.g., Greenstein v. Paul*, 400 F.2d 580, 581 (2d Cir. 1968), *Haberman v. Murchison*, 468 F.2d 1305, 1311 (2d Cir. 1972). And the Third, Fifth, Sixth and Eighth Circuits have all joined the Second Circuit on this point. *E.g., Landy v. Federal Deposit Insurance Corp.*, 486 F.2d 139, 156-57 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); *Rekant v. Desser*, 425 F.2d 872, 879 (5th Cir. 1970); *Sargent v. Genesco, Inc.*, 492 F.2d 750, 763 (5th Cir. 1974); *Simmons v. Wolfson*, 428 F.2d 455, 456 (6th Cir. 1970), *cert. denied*, 400 U.S. 999 (1971); *City National Bank v. Vanderboom*, 422 F.2d 221, 227-28 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); *Vanderboom v. Sexton*, 422 F.2d 1233, 1243 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970); and *Erling v. Powell*, 429 F.2d 795, 799-800 (8th Cir. 1970).

The Seventh Circuit has said it has rejected the *Birnbaum* rule and permitted an non-purchasing, non-selling *investor* to sue for damages under rule 10b-5. *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974) (Burger, C.J., Douglas and White, JJ., dissenting from denial of certiorari; Powell, J., not participating.)[16]

[16] In *Eason* the plaintiffs were investors who held shares in a corporation and who had executed personal guarantees of notes in connection with the issuance of 7,000 shares of their corporation's stock to one of the defendants. They asserted their 10b-5 claims in response to a suit by a defendant on the guarantees. On these facts it could be argued that there is substantial question as to whether *Eason* is actually inconsistent with the line of authority requiring a plaintiff to be classifiable as a purchaser or seller of securities. But in any event, the plaintiffs in *Eason* were *investors*, unlike the respondent here.

No circuit has followed *Eason* and the Fifth Circuit has recently reaffirmed its adherence to *Birnbaum*, rejecting *Eason* in the process. *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 590 (5th Cir. 1974); *Sargent v. Genesco, Inc.*, 492 F.2d 750, 762-64 (5th Cir. 1974).

Despite the fact that its demise has been announced by some commentators,[17] and repeatedly sought by the SEC,[18] the purchaser-seller rule retains its vitality. The courts have read the terms "purchase" and "sale" so as to maximize the protection of investors and those trading in securities. Those who are parties to contracts for the purchase or sale of securities have been permitted to sue for damages under 10b-5, although no purchase or sale was actually consummated. *E.g., Opper v. Hancock Securities Corp.*, 367 F.2d 157 (3d Cir. 1966); *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967); *Commerce Reporting Co. v. Puretec, Inc.*, 290 F. Supp. 715 (S.D.N.Y. 1968). Where the fraud alleged has occurred in connection with a transaction having the effect of involuntarily forcing a sale by an investor or converting his securities to a claim for cash, the courts have allowed standing to seek damages without requiring the formal act of selling. *See, e.g., Vine v. Beneficial Finance Co.*, 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967); *Coffee v. Permian*

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[17] *E.g.*, Lowenfels, *The Demise of The Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968).

[18] Since at least 1967 the SEC, in briefs *amicus curiae*, has attacked the purchaser-seller rule and sought its elimination. It has been uniformly unsuccessful. *See, e.g., Vine v. Beneficial Finance Co.*, 374 F.2d 627, 636 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967); *Iroquois Industries Inc. v. Syracuse China Corp.*, 417 F.2d 963, 967 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970); *Rekant v. Desser*, 425 F.2d 872, 879 (5th Cir. 1970); *GAF Corp. v. Milstein*, 453 F.2d 709, 721 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972); *Drachman v. Harvey*, 453 F.2d 722, 736, 738 (2d Cir. 1972) *(in banc); Mount Clemens Industries, Inc. v. Bell*, 464 F.2d 339, 341 (9th Cir. 1972).

Corp., 434 F.2d 383, 385-86 (5th Cir. 1970), *cert. denied*, 412 U.S. 920 (1973). And a plaintiff who is a shareholder, but not a purchaser or seller of securities, may bring a derivative damage action on behalf of his corporation upon alleging it purchased or sold securities. *See, e.g., Schoenbaum v. Firstbrook*, 405 F.2d 215 (2d Cir. 1968) *(in banc), cert. denied*, 395 U.S. 906 (1969); *cf. Superintendent of Insurance v. Bankers Life and Casualty Co.*, 404 U.S. 6 (1971).

Non-purchasing, non-selling shareholders have been permitted by some courts to bring actions under 10b-5 for injunctive relief from fraud which, if successful, would harm a shareholder. But in so ruling the courts have drawn a distinction between actions seeking injunctive relief and actions seeking damages. *See Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540, 546-47 (2d Cir. 1967); *Greenstein v. Paul*, 400 F.2d 580, 581 (2d Cir. 1968); *Kahan v. Rosenstiel*, 424 F.2d 161, 173-74 (3d Cir.), *cert. denied*, 398 U.S. 950 (1970); *cf. SEC v. National Securities, Inc.*, 393 U.S. 453, 467 n.9 (1969).

Analytical precision may not be the hallmark of the large body of cases that establish the broad outline of the purchaser-seller doctrine; however, those decisions do effectively define the limits of that doctrine and show its continuing strength and flexibility.[19] *Birnbaum* grounded the purchaser-seller rule largely on the SEC's original

[19] For descriptions of the present dimensions of the purchaser-seller rule see, *e.g.*, Boone & McGowan, *Standing to Sue Under SEC Rule 10b-5*, 49 TEXAS L. REV. 617, 623-49 (1971); Note, *Rule 10b-5: The Rejection of the* Birnbaum *Doctrine by* Eason v. General Motors Acceptance Corp. *and the Need for a New Limitation on Damages*, 1974 DUKE L.J. 610, 616-17 n. 35 (1974); Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases*, 86 HARV. L. REV. 1007, 1017-18 n.49 (1973); Note, *The* Birnbaum *Rule Rejected: Will Analysis of Right to Bring Private Action Under § 10(b) be Simplified?*, 31 WASH. & LEE L. REV. 757, 759-65 (1974).

purpose for promulgating rule 10b-5, but in its present form the rule also serves to place reasonable limits on the broad exposure to damage liability that has developed under the section and rule. The purchaser-seller rule has been criticized primarily on grounds that it does not permit sufficient opportunity for shareholders to challenge action, such as mismanagement, that may have reduced the value of their securities. *See, e.g.*, Ruder, *Current Developments in the Federal Law of Corporate Fiduciary Relations — Standing to Sue Under Rule 10b-5*, 26 BUSINESS LAWYER 1289 (1971); Comment, *The Purchaser-Seller Rule: An Archaic Tool for Determining Standing Under Rule 10b-5*, 56 GEO. L.J. 1177 (1968); Kellogg, *The Inability to Obtain Analytical Precision Where Standing to Sue Under Rule 10b-5 is Involved*, 20 BUFF. L. REV. 93 (1970). The cases making injunctive relief available to non-purchasing, non-selling investors seem to be a movement in that direction. But while commentators have called for erosion of the purchaser-seller rule for the benefit of shareholders, it has not been seriously contended that the purposes of the Act and rule require the extension of standing to sue for damages to a non-purchasing, non-selling non-investor, such as respondent. *See, e.g.*, Comment, *supra*, 56 GEO. L.J. at 1186-87 & nn.68 & 69.

The decision of the Ninth Circuit here stands alone in abrogating the purchaser-seller doctrine and enunciating a rule that permits a non-purchasing, non-investor offeree to bring a damage action under 10b-5.

B. The decision of the court below effectively overthrows the purchaser-seller doctrine and cannot be limited to the facts of this case.

The court of appeals majority attempted to create the impression that its decision was not a departure from

existing purchaser-seller authority. It reasoned from the injunction cases that the justification for the purchaser-seller rule in damage actions rests

> "largely on the assumption that if plaintiff does not allege that he purchased or sold the stock involved in the fraud it is evident at the outset that his claim must fail 'both on proof of loss and the causal connection with the alleged violation of the Rule.' *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540, 547 (2d Cir. 1967). *See also Britt v. Cyril Bath Co.*, 417 F.2d 433, 435-36 (6th Cir. 1969); *cf. Rekant v. Desser*, 425 F.2d 872, 881 (5th Cir. 1970); Boone & McGowan, *Standing to Sue Under SEC Rule 10b-5*, 49 Texas L. Rev. 617, 646 (1971); Kellogg, *The Inability to Obtain Analytical Precision Where Standing to Sue Under Rule 10b-5 Is Involved*, 20 Buffalo L. Rev. 93, 114-16 (1970).
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> "This assumption is usually justified. Ordinarily there will be little proof (other than the non-purchaser's own opinion, after the loss) that the non-purchaser would in fact have purchased but for the fraud, and, if so, how much, when, or at what price; also, generally, the potential number of non-purchasers will be without definable limit. But this is not invariably true." (App. at 140-41.)

The majority said that standing to sue for damages has been allowed to "non-purchasers or non-sellers" when a contract to purchase or sell exists, and it suggested that this was due to the fact that contracts

> "often furnish objective evidence of the reality of a plaintiff's intention to purchase or sell but for the fraud, and thus of causation. They may also fix the price, quantity, and time of sale, thus making it possible to calculate damages. And the existence of such

> contracts permits a reasonable circumscription of a defendant's potential liability by identifying from among the limitless number of possible non-purchasers those few that the defendant chose to deal with himself. *See Commerce Reporting Co. v. Puretec, Inc., supra,* 290 F. Supp. at 719." (App. at 141.)

The majority concluded that "[u]nder the allegations of this complaint, the consent decree involved here serves the same function as" the contractual relationship found in other cases granting standing to sue because it fixed the terms of the offering and gave respondent "a right to buy" a portion of the offered securities. (App. at 141, 155.) The complaint's allegation as to the price at which some of the petitioners later sold some of their stock was seen as fixing an "objective measure of the amount of loss," and the allegation that the offering to users was at a price far below the true worth of the securities was seen as supporting an inference that "users properly informed rather than misled would have accepted the offer." (App. at 142; footnote omitted.) These allegations, then, were thought to reduce the speculativeness of respondent's claim enough to satisfy the purpose of the purchaser-seller rule.

The majority's reasoning is patently defective. First, although it may well be true that one who has purchased or sold securities has a less speculative claim than one who has not, this is hardly the sole justification for the purchaser-seller requirement in damage cases. The court in *Mutual Shares Corp. v. Genesco, Inc.,* 384 F.2d 540, 547 (2d Cir. 1967), did suggest that absent a purchase or sale, loss and causation will necessarily be difficult to prove. But as Judge Hufstedler pointed out, the ability to *allege* a purchase or sale says little about one's ability to *prove* the elements of one's case. (App. at 145, 147.) The

difficulty of proof suggested by *Mutual Shares* is only one factor supporting the purchaser-seller doctrine. *See* pp. 31-36, *infra*. Second, standing is allowed in cases involving contracts to purchase or sell securities not because the contract makes the plaintiff's allegations "non-speculative", but because the 1934 Act specifically defines the terms "purchase" and "sale" to include a contract to purchase or sell.[20] Finally, and most important from the standpoint of the decision's impact, the consent decree does not reduce the "speculative" nature of respondent's claims. The non-purchasing users are factually indistinguishable from any other class of persons who did not accept an offer to purchase securities in the course of an offering made to an identifiable group at a fixed price.

In finding the complaint's averments sufficiently non-speculative the majority purports to rely in part on the allegation that the consent decree gave respondent and other users a "right" to purchase the offered securities.[21] As Judge Hufstedler stated in her dissent,

> "the [users'] ability to prove causation and damages cannot be likened to that of parties who have contracted to buy or sell. Their situations are dissimilar because a contract creates legal rights between the parties. [The users] had no duties and no rights created by the consent decree. The decree could not have been enforced against them, and they could not

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[20] Sections 3(a)(13) and (14) of the 1934 Act, 15 U.S.C. § 78c (13) and (14), provide as follows:

> "(13) The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire.
>
> (14) The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."

[21] The majority's attempt to distinguish this case on the basis of the complaint's allegations concerning the intention of the consent decree is dealt with in Part II hereof, pp. 42 through 49, *infra*.

have enforced it, even if the parties to the action resulting in the decree had intended to benefit them specifically. [Citations omitted.] Because the consent decree creates no rights or duties in [the users], their commitment and ability to purchase the offered securities are far less definite than in a case in which a contract binds the parties. This want of definiteness renders [the users] far less able to prove causation and damages than those who have contracted to buy securities and negates the 'same function' conclusion that is the basis for the majority's grant of standing." (App. at 145-46, 155.)

The majority suggests that respondent is prima facie able to prove causation because the complaint alleges that under the consent decree and plan the units were a bargain, and, therefore, it can be inferred that any informed offeree would have bought. And the majority further suggests that respondent has sufficiently alleged an objective measure of damages by citing a price at which individual shares were sold over a year after the offering.[22] Neither allegation can serve to set the members of

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[22]The complaint appears to base its allegation of the "true" value of the units by reference to the $90 per share price (adjusted for an intervening 5 for 1 split) at which stock sold a year later. (App. at 15, 142.) And the measure of the alleged bargain is based on an assertion that the debenture was worth $75 and, therefore, that the price of the three shares was $8.67 each. (App. at 11, 18.) This is hardly an "objective" measure of the respondent's claimed loss. The units were only partially composed of stock; the other portion of the units was a $100 face amount, ten year debenture subordinated to many substantial risks, including antitrust claims against Blue Chip and possible claims under the indemnification agreements. P. 7, *supra*. The complaint alleges nothing which would serve as an "objective" justification for its allocation of the price of a unit among its components. Given the contingencies to which the debentures were subject, this seems necessary since the value of the debentures could, as a result, easily have been far less than $75, and the portion of the price attributable to the

the alleged class apart insofar as the speculative character of their claim is concerned. For any non-purchasing, non-selling offeree could allege that the securities he had an opportunity to buy were worth far more than he thought, that he would have known this fact had the defendant made a full and accurate disclosure, and that the measure of his damages, and the proof of true value and of causation, is the fact that the particular securities sold later at a higher price.

Thus, in satisfying the majority's "same function" test the consent decree and plan of reorganization fixed nothing more than the quantity of shares offered, the price, the time of sale and the general description of the offerees.[23] The first three of these are fixed in any offering of securities for sale. And in almost any situation an identifiable person or group of persons could be found (or alleged) who had an opportunity but failed to purchase offered securities.[24]

An example of a typical securities transaction that offers ample opportunity for application of the majority's "same function" test may be useful. A common method of distributing new securities is to employ underwriters. The principal underwriters arrange to purchase the

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shares, far more. In the present case, then, the complaint cannot be said to rely for an "objective" value on a subsequent transaction involving the same securities.

Insofar as the value of the stock alone is concerned, the complaint only mentions the alleged price over a year after the offering to users. But the second prospectus states that very shortly after the offering to users shares of new Blue Chip, severed from the debentures, sold in the market place at from $10 to $20 per share. (App. at 96 (adjusted for split).)

[23]The class of offerees here included at least 20,000 retailers who were users of Blue Chip's trading stamp service in 1968. *See* App. at 59, 64.

[24]Although this case is concerned with offers to sell, unaccepted offers to buy would also seem to provide a basis for a damage claim under the majority's reasoning.

issuer's securities and distribute them. Before the securities are issued they approach selected other members of the National Association of Securities Dealers and offer them an opportunity to participate in the distribution by agreeing to take varying amounts of the new issue. If the NASD member believes the securities are worthwhile, it will agree to take a number of shares, perhaps in some circumstances for its own account. The participating underwriters will attempt to sell the bulk of the securities to the investing public, typically contacting regular customers and offering them shares. Sometimes this offering to customers will be done before the registration process is completed and will amount to an offer to sell "when issued." By this type of transaction, of which there are infinite variations, billions of dollars in new securities are offered each year.[25]

The majority's rule would have a pervasive effect on such normal underwriting transactions. At the wholesale and retail level identifiable persons will be offered securities for purchase. Should it subsequently happen that the issue was underpriced and rose rapidly upon issuance,[26] any offeree could claim he had an opportunity to buy at a set price and upon set terms, that he did not appreciate the true value of the securities because of some unduly negative statement or some failure to reveal affirmative facts, that he would have

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[25] This is a simplistic description of the underwriting process. For a detailed discussion of the variety of transactions used to bring securities to the investing public by underwriting, see Judge Medina's lengthy opinion in *United States v. Morgan*, 118 F. Supp. 621 (S.D.N.Y. 1953). For discussion of the distribution and selling process, see Schneider & Manko, *Going Public – Practice, Procedure and Consequences*, 15 VILL. L. REV. 283, 287-96 (1970). (Portions of this article are reprinted as Appendix B to this brief at Br. App. (6) through (20).)

[26] For a discussion of why issues may be priced below the probable market price, see Schneider & Manko, *supra*, Br. App. at (10).

bought had he known the "bargain" nature of the offer, and that as a result he was wrongfully deprived of the "profit" he would have made had he bought. Or he might as easily allege he bought *less* of the offered securities than would have been the case had he not been misled. Here is "same function" at a level that confounds the imagination. And the impact upon the securities marketing system of such a rule would be enormous. In 1973 alone over $27 billion in new corporate securities were registered with the SEC for immediate cash sale; the value of all registrations exceeded $59 billion. THIRTY-NINTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION 163-66 (1973). Yet, as Judge Hufstedler said, there is no way to distinguish the respondent and its alleged class from other disappointed offerees, except that "their disappointment can be assuaged for no more than $21,000,000, rather than many times that amount." (App. at 149.)

Under the rule established by the majority, the *only* time one would have to have purchased or sold securities to obtain standing to sue for damages would be when he lacks the minimal creativity necessary to allege in a complaint facts that would bring his claim within the "same function" analysis or otherwise give it some surface appearance of non-speculativeness.

C. Balancing the benefits against the detriments that would result from permitting non-purchasing, non-investor offerees to sue for damages indicates that respondent should be precluded from suing.

When the language and purposes of the 1934 Act are considered and the detrimental effects of the ruling below are weighed, it becomes clear that standing to sue for damages should not be granted to non-purchasing, non-investor offerees.

In the context of a claim of standing by a non-investing offeree, the language of the rule and section are helpful in determining their intended reach. The limiting phrase in both is "in connection with the purchase or sale of any security." 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5; *see SEC v. National Securities, Inc.*, 393 U.S. 453, 465-68 (1969). The 1934 Act defines purchase or sale to include contracts to purchase or sell or otherwise dispose of. *See* p. 26, *supra*. That definition does not include an *offer* to purchase or sell. The parallel definitional section in the Securities Act of 1933 defines "sale" in much the same terms as the 1934 Act. *See* § 2(3), 15 U.S.C. § 77b(3). However, it separately defines "offer" as something distinct from a sale. Had Congress intended section 10(b) to reach offers, it knew how to accomplish that purpose. The failure to include simple offers within the terms of section 10(b) can be taken to indicate that they were not within the section's grant of authority to the SEC. Therefore, neither the section nor the rule should be extended to reach the situation alleged in the complaint.

This reading of the section and rule is confirmed by further analysis. The private cause of action asserted is wholly a judicial creation; therefore, the policies underlying the section and rule must be carefully considered to determine if the standing sought will, in view of its deleterious effects, substantially further those policies. If not, it should be denied. Generalizations about the protection of potential investors and maintaining the purity of stock transactions such as were relied upon by the court below help little in making this judgment.

Cases which have struck the balance differently depending on the status of the plaintiff and the nature of the remedy sought include those allowing injunctive actions by investors who have neither purhased nor sold.

It appears from those decisions that whatever the arguable semantic reach of the rule and section, the courts have concluded that an injunctive remedy ought to be available to a non-buying, non-selling investor, while a damage remedy ought not because of the problems it may present and the unlimited scope of the resulting liability. *See Mutual Shares Corp. v. Genesco, Inc., supra,* 384 F.2d. at 543-44. As Judge Hufstedler said of the majority's ruling below:

> "[E]xpansion of standing to bring suits for injunctive relief does not entail the risk of strike suits or of exposure to imponderable liability that expanded standing in damage actions threatens." (App. at 148.)

Permitting those with a present economic commitment to securities — investors — to sue for injunctive relief against wrongful conduct which would harm a selling investor seems an appropriate step. It permits the investor to act as a private attorney general to aid in enforcing the rule, and it avoids the anomalous result that one must await the consummation of the fraudulent conduct which threatens measurable harm and cannot sue to prevent it. At the same time, the prophylactic relief offered by an injunction is a relatively mild remedy in terms of its collateral effects upon legitimate activity. *See, e.g., SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 866-68 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) (concurring opinion of Friendly, J.).[27]

A damage remedy is a different matter, however. This is especially true when the party seeking damages is a

[27] No case has been found in which a plaintiff permitted to bring an injunctive action under 10b-5 was not at least an existing investor. Absent such a present interest in the securities in question, it seems unlikely that a plaintiff would be entitled to seek equitable prophylactic relief.

non-purchasing, non-selling *non-investor*. Testing the limits of the standing sought here against the purpose to be served and the effect it will have leads to the conclusion that it should be denied.

The supposed "injury" allegedly suffered by respondent and its alleged class is not one that cries out for compensation. Under the ruling below those who have never invested in, or made a legal commitment to the offered securities, as by purchasing or contracting to purchase, will be entitled to seek the profit they allegedly could have made had they accepted the offer, entered into the transaction and put their funds at risk. Despite the fact that they were never participants in the market, but sat on the sidelines watching for a period of time (here, two years) how the securities would do, they will be able to recover for their alleged "injury." The amount of the potential "profits" that could be sought *via* class actions for non-investors would be astronomical. And it could ultimately be paid out of the pocket of the company with which those who bought risked their funds. Note, *supra*, 1974 DUKE L.J. at 629-30.[28]

[28] There is a substantial question as to whether the harm allegedly suffered by respondent is compensible under section 28(a) of the 1934 Act, 15 U.S.C. § 78bb(a). "'Actual damages,' under the Federal rule of damages for fraud is the 'out of pocket rule.'" *Estate Counseling Service, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527, 533 (10th Cir. 1962). Such "liability does not include the expectant fruits of an unrealized speculation." *Id. See, e.g., Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert denied*, 390 U.S. 951 (1968); *Esplin v. Hirschi*, 402 F.2d 94, 104 (10th Cir. 1968), *cert. denied*, 394 U.S. 928 (1969); *Levine v. Seilon, Inc.*, 439 F.2d 328, 334 (2d Cir. 1971). Respondent has sustained no actual out of pocket loss because respondent had no contractual or other enforceable right to purchase at the offering price, and had given no consideration for the offer. P. 44 n.31, *infra*. The difference between the offering price and actual value at that time does not fit within the out of pocket rule. *Levine v. Seilon, Inc., supra*, 439 F.2d at 335.

Another factor weighing against a grant of standing to those such as respondent is mentioned by Judge Hufstedler:

> "The great ease with which plaintiffs can allege the requirements for the majority's standing rule and the greater difficulty that plaintiffs are going to have proving the allegations suggests that the majority's rule will allow a relatively high proportion of 'bad' cases into court. This risk of strike suits is particularly high in such cases; although they are difficult to prove at trial, they are even more difficult to dispose of before trial." (App. at 151 n.9.)

The potential for abuse inherent in the ruling is extremely high. Virtually any non-purchasing offeree will be able to state — although perhaps not prove — a claim on behalf of himself and a class by simply alleging that but for the defendant's wrongful activities, plaintiff and the members of its class would have purchased securities which were offered to them at a price below their true value. The fact that any non-purchasing offeree will be able to impose the costs and risks of possibly mammoth litigation on a defendant does not appear to trouble the SEC or the court below. They seem to think that the problem of the unmeritorious action will be resolved summarily during the course of litigation on the merits. (App. at 142); *see* Memorandum for SEC as *amicus curiae* at 9 (filed Nov. 7, 1974). This view is extremely unrealistic.

The few defined elements of a 10b-5 action have been substantially eroded over the years. *E.g.,* Boone & McGowan, *supra,* 49 Texas L. Rev. at 619-20; *see* 1 A. Bromberg, *supra,* § 4.7 at (500) *et seq.* This has facilitated the maintenance of large class actions creating much greater exposure to liability for defendants, and providing much less opportunity to test the meritorious

character of the plaintiff's case short of full trial. For example, while in one cause respondent has alleged intentional misrepresentations and omissions, in another it alleges simple negligence. (App. at 20.) A number of courts hold negligence a sufficient mental state for a finding of liability. *See, e.g., Clement A. Evans & Co. v. McAlpine,* 434 F.2d 100, 104 (5th Cir. 1970), *cert. denied,* 402 U.S. 988 (1971); *Mitchell v. Texas Gulf Sulphur Co.,* 446 F.2d 90, 102 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971); *City National Bank v. Vanderboom,* 422 F.2d 221, 229-30 (8th Cir.), *cert. denied,* 399 U.S. 905 (1970). Similarly, although respondent alleges it and the members of the alleged class relied on the negative prospectus, decisional law indicates that where an omission to state material facts is involved, actual reliance need not be shown. *See, e.g., Affiliated Ute Citizens v. United States, supra,* 406 U.S. at 153-54; *Herbst v. ITT,* 495 F.2d 1308, 1315 (2d Cir. 1974); *Rochez Bros., Inc. v. Rhoades,* 491 F.2d 402, 410 (3d Cir. 1974); *Swanson v. American Consumers Industries, Inc.,* 475 F.2d 516, 520-21, 523 (7th Cir. 1973). And the amended complaint alleges omissions. (App. at 13, 16-17.)

It should be plain that a non-purchasing, non-investor offeree will be able to state a broad class claim and easily avoid summary dismissal. It should be equally plain that the rule adopted below has tremendous potential for extortion. Regardless of the merits of the case, few if any defendants would be willing to run the risk that a finder of fact would decide that the elements of a claim had been proven and, on the basis of subjective evidence, that the plaintiffs would have bought had they known all the facts. *See. e.g.,* Boone & McGowan, *supra,* 49 Texas L. Rev. at 648-49; Note, *supra,* 1974 Duke L.J. at 624-31.

To some degree the problems set forth above are already present in 10b-5 class action litigation. *Id.*

However, the decision of the court below opens vistas of potential liability, and almost certain litigation, far beyond what exists under the purchaser-seller doctrine. These consequences surely do not serve the purposes of the section or the rule and argue strongly that extending standing to seek damages to non-purchasing, non-selling non-investing offerees is not worth the price. Judge Hufstedler made this point:

> "An expansive definition of the class given standing to pursue section 10(b) damage actions promises some incremental benefit in preventing deceptive practices in the marketing of securities, one of the principal purposes of the section. Expanding the class, however, entails costs as well as benefits. Incautious loosening of the purchaser-seller rule will generate federal litigation, increase the cost of marketing securities, inject into securities marketing new risk factors that defy accurate assessment, expose offerors to draconian damage claims, and invite strike suits. Securities markets are complex and sensitive institutions. Opening the valve, even a little, that controls the flow of section 10(b) damage actions can so far unsettle the market as to defeat, rather than to promote, the benevolent purposes of Congress in enacting the statute." (App. at 151-52; footnotes and citation omitted.)

D. The *Birnbaum* doctrine serves to prevent a direct conflict between implied liability under the Securities Exchange Act of 1934 and the Securities Act of 1933's express policy of full disclosure.

Perhaps the most important factor that weighs against granting standing to non-purchasing offerees such as respondent is the conflict that results between the 1934 Act

and the Securities Act of 1933 when the offer involved is one made pursuant to a 1933 Act prospectus.

The evil at which the 1933 Act was aimed was the then general practice of failing to disclose to investors adverse or potentially adverse material facts while emphasizing all positive facts, thus effectively "puffing" or overstating the value of offered securities. The House report that accompanied the House version of the Act stated the problem:

> "During the post-war decade some 50 billions of new securities were floated in the United States. Fully half or $25,000,000,000 worth of securities floated during this period have been proved to be worthless. These cold figures spell tragedy in the lives of thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities. The flotation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest, and prudent dealing that should be basic to the encouragement of investment in any enterprise. Alluring promises of easy wealth were freely made with little or no attempt to bring to the investor's attention those facts essential to estimating the worth of any security. High-pressure salesmanship rather than careful counsel was the rule in this most dangerous of enterprises." H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933).

In response Congress enacted the registration and prospectus provisions of the 1933 Act, which require, *inter alia*, that all material facts be disclosed in a prospectus. *See* § 10(a), 15 U.S.C. § 77j(a). The House report described the sections specifying the contents of a prospectus as follows:

"The purpose of these sections is to secure for potential buyers the means of understanding the intricacies of the transaction into which they are invited. The full revelations required in the filed 'registration statement' should not be lost in the actual selling process. This requirement will undoubtedly limit the selling arguments hitherto employed. That is its purpose. . . . Any objection that the compulsory incorporation in selling literature and sales argument of substantially all information concerning the issue, will frighten the buyer with the intricacy of the transaction, states one of the best arguments for the provision. The rank and file of securities buyers who have hitherto bought blindly should be made aware that securities are intricate merchandise." H.R. Rep. No. 85, 73d Cong., 1st Sess. 8 (1933).

The courts and the SEC have made it plain that all material facts, including adverse contingencies, must be revealed. *See, e.g., Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (*in banc*); *Escott v. BarChris Const. Corp.*, 283 F. Supp. 643, 680-81 (S.D.N.Y. 1968); *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 569-71 (E.D.N.Y. 1971) (collecting and analyzing the authorities). The adverse facts cannot merely be disclosed: They must be given emphasis sufficient to convey their importance and the risks they portend for the investor. *See Mills v. Electric Autolite Co.*, 403 F.2d 429, 434 (7th Cir. 1968), *vacated on other grounds*, 396 U.S. 375, 381 & n.4 (1970); *Richland v. Crandall*, 262 F. Supp. 538, 553-54 (S.D.N.Y. 1967); *Feit v. Leasco Data Processing Equipment Corp., supra*, 332 F. Supp. at 564-65. The SEC has held that a failure to emphasize pertinent risk factors in a prospectus and in a registration statement constitutes a material failure to comply with the disclosure requirements of the 1933 Act. *E.g., Doman Helicopters, Inc.*,

41 S.E.C. 431, 439 (1963); *Universal Camera Corp.*, 19 S.E.C. 648, 652, 654-56 (1945). See SEC Securities Act Release No. 4936, *Guides for Preparation and Filing of Registration Statements*, p. 6, ¶ 6 (1968).[29]

This requirement of disclosure and emphasis on adverse matters comports with Congress' purpose of protecting investors from issuers "puffing" the value of their securities by minimizing the risks inherent in their purchase. To assure that issuers refrain from transgressing the limits of this policy, Congress enacted, *inter alia*, section 11 of the 1933 Act, 15 U.S.C. § 77k.[30] This section permits a purchaser to sue the issuer for damages occasioned by a decline in the price of the purchased securities, without regard to reliance by the purchaser upon the prospectus. He need show no more than that the prospectus (which is filed with and constructively constitutes a portion of the registration statement) contains "an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." The non-negligence of the issuer is no defense to such an action.

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[29] The complaint's principal claims regarding the 1968 prospectus are that it gave emphasis to certain adverse contingencies to which the debentures and the company were subject by including a list of them on the second page of the prospectus. *See* pp. 8-10, *supra*. But SEC practice specifically requires such listings of risk factors for emphasis. *See* SEC Securities Act Release No. 4936, as amended, *Guides for Preparation and Filing of Registration Statements*, p. 6, ¶ 6 (1968) (portions of the *Guides* are reprinted as Appendix C to this brief at Br. App. (21) through (25)); Wheat & Blackstone, *Guideposts for a First Public Offering*, 15 BUSINESS LAWYER 539, 560-62 (1960) (portions of this article are reprinted as Appendix D to this brief at Br. App. (26) through (31)).

For a discussion of how the registration process works, see Schneider & Manko, *supra*, 15 VILL. L. REV. 283 (1970), Br. App. at (11)-(17).

[30] Relevant portions of this statute are contained in Appendix A to this brief, Br. App. at (1)-(5).

§ 11(b), 15 U.S.C. § 77k(b). "Section 11 creates almost absolute liability in the issuer." *Feit v. Leasco Data Processing Corp.*, 332 F. Supp. 544, 575 (E.D.N.Y. 1971) (citing authorities).

Substantially similar liability is imposed by section 11 upon inside directors of the issuer. "Their liability approaches that of the issuer as a guarantor of the accuracy of the prospectus." 332 F.Supp. at 578. *See also* § 12, 15 U.S.C. § 77*l* (liability of persons selling securities by means of the prospectus). And this standard of liability is supplemented by possibly broader but less stringent liability imposed under rule 10b-5. *See, e.g., Lanza v. Drexel & Co.*, [1970-71 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92, 826 (S.D.N.Y. 1970); *cf. Feit v. Leasco Data Processing Corp., supra*, 332 F. Supp. at 584.

The 1933 Act, then, forces a prospectus draftsman to disclose fully and to emphasize amply adverse contingencies. This necessarily requires that he make predictive judgments as to the future impact they may have on the offered securities and the business of the issuer. By couching his descriptions and predictions in conservative and cautionary terms, he can seek both to protect the issuer and its directors from liability under section 11, and to preclude the purchaser from buying without fully appreciating the risks of the investment. SEC practice specifically encourages such an approach to prospectus drafting. *See* pp. 38-39 and n.29, *supra*, and authorities there cited.

In the face of 1933 Act policy and practice, the court of appeals has held that one who does not purchase securities offered by means of a prospectus can sue for damages under rule 10b-5 and section 10(b) of the 1934 Act if he alleges that the adverse matters appear in hindsight to have been over-emphasized. Granting standing to such

a non-purchasing offeree is to confront the prospectus draftsman with an impossible task: (i) disclose and emphasize adverse contingencies, on pain of purchasers suing to recover for a disclosure which under-estimated the risks involved; and (ii) do not emphasize adverse contingencies, on pain of non-purchasers suing to recover damages for a disclosure which over-estimated the risks of the investment.

Judge Hufstedler stressed the dilemma created:

> "The accuracy of a representation with regard to a security is usually judged by hindsight; if the price of the security rises substantially, prior representations may seem unduly conservative; if it falls, too optimistic. Under the purchaser-seller rule, offerors can protect themselves against unforeseen impositions of liability by acting with judicious restraint when dealing with others; they need merely avoid inaccuracies that induce others to act. If passive 'investors' were also allowed to sue, such self-protective conservatism might prove suicidal, for an offeror would have to be micrometrically accurate." (App. at 151 n.8.)

Overturning the purchaser-seller rule in the context of an offering made pursuant to a 1933 Act prospectus increases the probability that a given prospectus will be overly optimistic, or at least will give less than full emphasis to adverse facts. In the final analysis, the investing public will receive less protection against "puffing" and issuers will have an immensely greater exposure to liability, an almost certain exposure to costly litigation. Neither exposure will be avoidable, as Judge Hufstedler observed.

> "To expand standing to nonsellers or to nonbuyers, like appellants, who have taken no affirmative action

of any kind in reliance upon alleged deceptive statements invites litigation that has nothing to do with protecting the integrity of the marketing of securities. The passive investor could always await market developments without any risk, claiming deception caused nonbuying if the value of the securities proved more promising than the offerors' glum predictions and deception caused nonselling if a rosier prospectus was followed by a market decline. Meanwhile, securities offerors would be hard pressed to find language for prospectuses that would be sufficiently neutral to avoid potential damage suits from bystanders." (App. at 152-53.)

In the situation presented here the purchaser-seller rule serves the legitimate function of harmonizing the 1933 and 1934 Acts. At the same time it protects the actual investor and provides a buffer zone within which a prospectus draftsman can work.

II.

TO THE EXTENT THE DECISION BELOW GAVE RESPONDENT STANDING UNDER RULE 10b-5 BECAUSE OF THE USERS' ALLEGED "RIGHTS" UNDER THE DECREE, IT IS ERRONEOUS AND CONFLICTS WITH DECISIONS WHICH REFUSE TO PERMIT A NON-PARTY TO AN ANTITRUST CONSENT DECREE TO ASSERT IN A SEPARATE PROCEEDING RIGHTS ALLEGED TO DERIVE FROM FROM THAT DECREE.

The decision of the court of appeals cannot be limited to its facts. The majority appears to have thought it found in the consent decree a basis for distinguishing respondent from other disappointed offerees. However,

to the extent that the grant of standing to respondent is based upon the complaint's allegations regarding the intention of the consent decree, it is in conflict with this Court's decision in *United States v. Armour & Co.*, 402 U.S. 673 (1971), and with the Eighth Circuit's decision in *Data Processing Financial & General Corp. v. IBM Corp.*, 430 F.2d 1277 (8th Cir. 1970), *aff'g sub nom. Control Data Corp. v. IBM Corp.*, 306 F. Supp. 839 (D. Minn. 1969).

The majority's opinion relies heavily upon the complaint's averments that under the consent decree the respondent had a "right" to purchase the securities offered, and that the court and government "intended" the offering to be a "bargain" to compensate the non-shareholder users for their "interest" in old Blue Chip's retained profits. All this was supposedly "prompted" by the arguments presented to the antitrust court by users who were not parties to the government case. (App. at 135-36, 141-42.)

But the consent decree does not mention the offering, and the plan of reorganization provides only that the units are to be offered to the users at a set price and upon certain terms. Neither decree nor plan mentions the alleged claims of the users to old Blue Chip's profits, decrees any "interest" of the users in Blue Chip, or states that the offering is intended to be, or will in fact be, a "bargain" offering. Therefore, the decree and plan do no more than identify the offerees and fix the terms of the offering.

In any event, the allegation that the offering was a bargain does not factually distinguish this case because any non-purchasing offeree could similarly allege that securities offered to him were really worth more than the asking price. And, of course, any non-purchasing offeree

who failed to take advantage of a "bargain" could allege causation as well as has respondent. *See* pp. 27-28, *supra.*

The only characteristic about respondent and its alleged class that might theoretically set them apart from the general run of non-purchasing offerees is the claim that the consent decree court intended the non-shareholder users to be the beneficiaries of the decree and to have "rights" under it because of their claim to an interest in old Blue Chip. However, these "rights" are simply conclusions of the pleader based on unsupported allegations as to the antitrust court's intention to benefit the respondent.[31] And to found the supposed "rights" on an allegation as to the unexpressed intention of the antitrust court is to misunderstand the nature of a consent decree.

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[31] The respondent's allegation that the so-called "rights" were in recognition of the users' claims is not supported by the record facts. The users were not parties to the antitrust action and the consent decree makes no adjudication respecting claims of the users or anyone else. (App. at 23-24.) Therefore, any claims the users had were unaffected by the consent decree. And it was not a condition of the unit offering that users accepting the offer must relinquish any claims. They would be completely free to assert them after purchasing the units. The offering cannot, then, be considered some sort of compensation or *quid pro quo* by which the users' alleged claims were exchanged for rights to purchase units.

At least one *amicus* submitted a paper to the antitrust court dealing squarely with that court's view of the users' claim to an equitable interest in Blue Chip. In a brief filed on behalf of Raley's Inc. by counsel for respondent here, it was adamantly stated:

> "[I]f the approximate 28,000 'potential stockholders' . . . had an equitable claim, they will still have it after they acquire the stock. There are no releases of any claim required as a condition for the purchase of the stock. In fact, there may be thousands of purchasers of Blue Chip stamps who purchased their stamps before March 1964, the earliest cutoff date for eligibility . . . . Does the purported 'equitable claim' to the assets of Blue Chip continue to exist in these individuals as well?
>
> "*But this Court has already expressed itself upon the lack of legal soundness of this so-called equitable claim.* The

In *United States v. Armour & Co.*, 402 U.S. 673 (1971), the government sought certain relief under the 1920 meatpackers' consent decree on grounds that it was necessary to effectuate the decree's purposes. In affirming a denial of the requested relief the Court held that consent decrees, unlike decrees entered after full litigation through judgment, cannot be said to have any purposes. Rather, the parties to the decree have purposes which are generally opposed to each other, and

> "the resultant decree embodies as much of those opposing purposes as the respective parties have the bargaining power and skill to achieve. For these reasons, the scope of a consent decree must be discerned within its four corners, and not by reference to what might satisfy the purposes of one of the parties to it. Because the defendant has, by the decree, waived his right to litigate the issues raised, a right guaranteed to him by the Due Process Clause, the conditions upon which he has given that waiver must be respected, and the instrument must be construed as it is written . . . ." 402 U.S. at 681-82 (footnote omitted).

Even assuming, contrary to *Armour*, that allegations of a consent decree's unexpressed intentions will support a claim by a plaintiff to beneficiary status under that decree, the policies underlying antitrust consent decrees preclude such a plaintiff from maintaining an action under the 1934 Act that it would not otherwise be entitled to bring. To grant respondent standing under 10b-5 is inconsistent with the established rule that a

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facts support this Court's opinion." Quoted in Reply to Plaintiff-Appellant's Supplemental Brief at 5-6 (filed Sept. 13, 1972). (The briefs submitted to the court of appeals are not part of the record here; however, they have been lodged with the Clerk of this Court at the request of the parties.)

non-party to a consent decree cannot sue to enforce the provisions of that decree, *e.g., Buckeye Coal & Ry. v. Hocking Valley Ry.*, 269 U.S. 42, 47-49 (1925); *United States v. ASCAP*, 341 F.2d 1003, 1007-8 (2d Cir.), *cert. denied*, 382 U.S. 877 (1965); *see, e.g., Dahl, Inc. v. Roy Cooper Co.*, 448 F.2d 17, 20 (9th Cir. 1971), and is in direct conflict with the Eighth Circuit's decision in *Data Processing Financial & General Corp. v. IBM Corp.*, 430 F.2d 1277 (8th Cir. 1970), *aff'g sub nom. Control Data Corp. v. IBM Corp.*, 306 F. Supp. 839 (D. Minn. 1969).

In *Control Data* claims were made by non-parties to earlier consent decrees that they were the intended recipients of benefits to flow from those decrees and had a right to relief if the defendant thwarted their realizing those benefits. The district court ordered the claims stricken from the pleadings.

The court reasoned that the Attorney General is the representative of the public in government antitrust suits, and under established authority only parties can derive rights from or sue to enforce a consent decree terminating a government action. The pro-consent decree policies underlying this rule also require that non-parties to decrees, even if direct and intended beneficiaries, be denied standing to do, through a separate suit bottomed upon the obligations imposed by the decree, what they could not do directly — enforce the decree. 306 F. Supp. at 845-48. The actions were ordered to proceed as though the decrees had never been entered. The court of appeals affirmed, having approved the district court's reasoning. 430 F.2d at 1278.

The decision below, to the extent it allows respondent standing under rule 10b-5 because of the alleged intent of the consent decree, permits exactly the indirect enforcement of a decree that was rejected in *Control Data*. The

reasons for denying non-parties the ability to assert rights alleged to flow from a consent decree are forceful. As Judge Hufstedler stated:

> "A persuasive rationale for refusing to accord nonparties standing to enforce a consent decree is that the potential exposure to litigation and to liability that a contrary rule would engender would seriously impair the settlement of litigation. The public interest in obtaining consent decrees outweighs the interest of the nonparty litigants in obtaining direct vindication of their private interests. Control Data Corp. v. IBM Corp. (D. Minn. 1969) 306 F.Supp. 839, 846. If administration of the antitrust laws would be ill served by allowing direct enforcement of consent decrees by third parties, it is difficult to understand how it would be better served by the creation of 'rights', like that created by the majority opinion, that permit indirect enforcement of the decrees." (App. at 145-46 n.3.)

To permit non-parties to assert rights allegedly arising as a result of consent decrees can only be destructive of the Department of Justice's program for terminating the vast majority of government antitrust actions *via* consent decree. If antitrust defendants, such as petitioners, cannot be assured that their liabilities under a negotiated decree will be limited to those agreed to by the parties to the action, then they will be much more reluctant to give up their right to litigate.

Moreover, defendants in hundreds of government actions have entered consent decrees over the years with the understanding that their liabilities were carefully circumscribed. (The *Control Data* court mentioned some 495 consent decrees that had been entered in the period 1944-1969. 306 F.Supp. at 846.) The decision below would

work a retroactive revision of those decrees by allowing non-parties to come forward and claim enforceable rights under them. Such a result denies due process to those who gave up their right to defend themselves in exchange for a negotiated decree. *See United States v. Armour & Co., supra,* 402 U.S. at 681-82; *Control Data Corp. v. IBM Corp., supra,* 306 F. Supp. at 846-48.

For the foregoing reasons the 10b-5 standing decision made with respect to respondent here cannot be limited in its scope by the presence of the consent decree.[32]

As is suggested by the court in *Control Data,* the respondent is not without avenues for presenting its alleged grievances regarding the manner in which the offering was made. The respondent might attempt to persuade the Antitrust Division of the Department of Justice that the decree has been frustrated by petitioners' alleged misconduct, and that corrective action should be sought by the government from the antitrust court.[33] Apparently the respondent chose not to attempt to convince the government of the correctness of its views regarding the decree. Or perhaps the attempt was made, but was unsuccessful.

Alternatively, respondent might have applied for leave to intervene in the antitrust case as a party to assert frustration of the decree's purposes. But it did not do so. Instead, respondent chose to commence this class action seeking damages under the federal securities laws, and a state court class action raising claims under California

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[32] The court of appeals statement that respondent had not appealed the dismissal of its pendent claim under the decree is incorrect. (*Compare* App. at 141 n.14 *with* App. at 132.) The district court correctly decided the point.

[33] The decree provides for a reservation of jurisdiction by the antitrust court to entertain applications by "any of the parties" for enforcement or modification of the decree, or to punish violations of it. (App. at 35.)

law. *Manor Drug Stores v. Blue Chip Stamps,* No. C-5652 in the Superior Court, County of Los Angeles.[34]

If the antitrust decree created any rights in the non-shareholder users, then the antitrust court is clearly the proper forum for respondent's claims. United States District Judge Warren J. Ferguson handled the government antitrust action and signed the consent decree. Because some of the provisions of the consent decree have not yet been implemented, the matter is still pending before Judge Ferguson. There can be no better forum for determining the "intention" of the court, parties and decree that terminated the lengthy antitrust proceeding.

CONCLUSION

For the foregoing reasons the decision of the court of appeals should be reversed and the district court's order dismissing the amended complaint reinstated.

Respectfully submitted,

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(Continued on following page.)

[34] The state action has been in abeyance pending disposition of the federal action.

Thrifty Drug Stores Co., Inc., Vons Grocery Co., Robert E. Alexander, Donald A. Koeppel, Leonard H. Straus, William F. Ramsey, Robert E. Laverty, Richard Ralphs, John R. Niven and Fred Von der Ahe.

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December, 1974

Appendix A

Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k

§ 77k. Civil liabilities on account of false registration statement.

(a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue —

(1) every person who signed the registration statement;

(2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or

valuation, which purports to have been prepared or certified by him;

(5) every underwriter with respect to such security.

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

(b) Notwithstanding the provisions of subsection (a) of this section no person, *other than the issuer,* shall be liable as provided therein who shall sustain the burden of proof —

(1) that before the effective date of the part of the registration statement with respect to which his liability is asserted (A) he had resigned from or had taken such steps as are permitted by law to resign from, or ceased or refused to act in, every office, capacity, or relationship in which he was described in the registration statement as acting or agreeing to act, and (B) he had advised the Commission and the issuer in writing that he had taken such action and that he would not be responsible for such part of the registration statement; or

(2) that if such part of the registration statement became effective without his knowledge, upon becoming aware of such fact he forthwith acted and advised the Commission, in accordance with paragraph (1) of this

subsection, and, in addition, gave reasonable public notice that such part of the registration statement had become effective without his knowledge; or

(3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading; and . . . .

* * *

(e) The suit authorized under subsection (a) of this section may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought: *Provided,* That if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted,

not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable. In no event shall any underwriter (unless such underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting) be liable in any suit or as a consequence of suits authorized under subsection (a) of this section for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public. In any suit under this or any other section of this subchapter the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit, such costs to be taxed in the manner usually provided for taxing of costs in the court in which the suit was heard.

(f) All or any one or more of the persons specified in subsection (a) of this section shall be jointly and severally liable, and every person who becomes liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation.

(g) In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public.

(Emphasis added in paragraph (b).)

Appendix B

[Excerpts from Schneider* & Manko,** GOING PUBLIC — PRACTICE, PROCEDURE AND CONSEQUENCES, 15 VILL. L. REV. 283, 287-96 (1970).]

SELECTION OF AN UNDERWRITER

Once the decision has been made to go public, the parties immediately face perhaps the most important decision to be made — selecting the managing underwriter. Investment banking firms vary widely in prestige, financial strength and ability to provide the various services which the company can expect. Some underwriters are not ordinarily interested in first offerings, while others handle very few issues other than first offerings. Some underwriters have particular stature and experience in specific industries. Underwriters may have pre-existing relationships with customers, suppliers or competitors of a prospective company going public, which can be both an advantage and a disadvantage from varying points of view. In short, a managing underwriter appropriate for one company may be wholly inappropriate for another.

In selecting the underwriters, advice should be obtained from experienced advisers who have a background in the area of public offerings. The company's attorneys, auditors and bankers may be helpful in making the selection. Some advisers, particularly underwriters them-

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selves, warn of dire consequences from "shopping" an offering, and suggest dealing with a single underwriter at a time. Opinions on this subject vary. There are some small and speculative offerings where the trick is to find any underwriter, and there may be little chance for selection. Additionally, among smaller underwriters, there may be a reluctance to evaluate, negotiate and otherwise develop an underwriting prospect unless the company is dealing exclusively with the particular firm at that time.

On the other hand, if the proposed offering is good enough to appeal to the larger underwriters, management may be best advised to select a few firms, possibly three to five, with which to begin preliminary discussions more or less simultaneously. If the offering has merit, the larger underwriters normally are most willing to spend time investigating the company to decide whether or not they wish to proceed, and thereafter to sell themselves and their proposal if they do wish to handle the transaction. It is important to deal in candor. Each prospective underwriter should be told that other underwriters are being considered. For offerings of genuine merit, this element of competition may well whet the appetite and stand the company in good stead. This is not to suggest, however, that a company should put itself in an auction, trying to get each bidder to top the others.

Finally, it must be stressed that price is not the sole element of comparison, nor is it necessarily advantageous for the stock to be sold for the very top dollar which any prospective underwriter will offer. If the initial offering price is set too high, the issue may have a poor reception and a weak after-market for some time to follow. Some underwriters will frankly advise the company to set the initial offering price slightly under the projected after-market price, perhaps 5 percent to 10 percent below,

simply to assure a good reception for the stock. For companies with a good history and earnings record, the proper pricing of the issue often must be determined by the market conditions prevailing at the offering date. Therefore, many underwriters will indicate during the preliminary negotiations the price, or price range, at which the offering could be made if it were being made at that time, with the express reservation that final pricing will be determined by prevailing conditions on the offering date which is normally at least a few months in the future. Thus, the managing underwriter is often selected at a time when the parties have not yet fixed the specific offering price.

Before the underwriters are selected, the company should investigate the after-market performance of the underwriters' prior offerings. Some companies go public only to find limited after-market interest following completion of the underwriting, with the result that the stock does not reach the price levels which the company projects on the basis of the performance of comparable issues. The managing underwriter should have a good record in forming syndicates which provide strong after-market interest and support for their offerings.

Several services can be expected from the underwriters. Initially, the managing underwriter will take the lead in forming the underwriting syndicate. The underwriters are also expected to provide after-market support for the security being sold. They may serve as over-the-counter market makers which stand ready to purchase or sell the stock in the inter-dealer market; they may purchase the stock for their own account; and they may take the initiative in bringing the stock to the attention of public investors, including their own customers. Ideally, the company should seek a managing underwriter which

customarily makes a continuous inter-dealer market for the issues it manages, although there are some managing underwriters that do not perform this function themselves.

In addition, the managing underwriter traditionally supplies other investment banking services to the company following the offering. They will assist in obtaining additional financing from public or private sources as the need arises, advise the company concerning possible acquisitions and generally make available their expertise as financial institutions. In many cases they will recommend or furnish experienced men to become members of the company's board of directors, or to serve as officers or key employees of the company.

All things considered, it is best for the company to select as manager the strongest underwriter willing to handle the offering, subject to an important qualification. If the company aims too high, and selects a firm which might consider the company an unimportant client, the underwriter may not have the necessary interest in the company and may not take the time to supply the follow-up services. Thus, for a relatively small offering, the company may do best with a relatively small firm or a strong regional firm based in its area, rather than a giant Wall Street firm. The company should be an important client to its investment banker, a client which will have top personnel assigned to it and receive the most prompt and effective service which the investment banker can render.

Structure of the Offering

Once a company has decided to make a public offering, it must determine, in consultation with its managing underwriter, what class of securities should be offered.

Most first offerings include common stock. Some first offerings consist of a package including other securities such as debentures, which may or may not be convertible into common stock, or warrants to purchase common stock. It is normally not practicable to have a publicly traded security convertible into common stock or a publicly traded warrant to purchase common stock unless a public market exists for the underlying common stock.

There are two other interrelated variables to consider, the number of shares offered and the offering price for the shares. It is generally felt that a minimum of 200,000 to 250,000 shares, and preferably 300,000 shares or even slightly more, is desirable in the public "float" to constitute a broad national distribution and to support an active trading market thereafter. As to price level, many of the larger investment banking firms and many investors are not particularly interested in dealing with securities offered at less than $10. The $5 level is often another psychological break point below which many investment bankers and investors lose interest. Any offering with an initial offering price of $20 or more is likely to import a prestige image.

For an offering of $3,000,000, 300,000 shares at $10 per share would be considered in the optimum range. If the offering is below $2,000,000 a decrease in the offering price per share is recommended, rather than a reduction in the number of shares offered below 200,000. These are matters of judgment, however, which should be reviewed carefully with the underwriters in each specific fact situation. In determining the amount of public investment which can be profitably employed in the business, the underwriters will normally evaluate the company's needs for funds and the dilution in earnings per share to result from the issuance of additional stock. If the optimum

level of proceeds to the company would constitute too small an offering, it may be desirable for existing shareholders to sell some of their own shares as part of the offering in order to increase its size. Sometimes the underwriters will suggest, or even insist, on a partial secondary offering with some shares to be sold by existing shareholders even though the shareholders would prefer to retain all of their shares.

The Registration Statement

The registration statement is the disclosure document required to be filed with the SEC in connection with a registered offering. It consists physically of two principal parts. Part I of the registration statement is the prospectus, which is the only part that normally goes to the public offerees of the securities. It is the legal offering document. Part II of the registration statement contains supplemental information which is available for public inspection at the office of the SEC.

The registration "forms" contain a series of detailed "items" and instructions, in response to which disclosures must be made. But, they are not forms in the sense that they have blanks to be completed like a tax return. Traditionally, the prospectus describes the company's business and responds to all the disclosures required in narrative rather than item-and-answer form. It is prepared as a brochure describing the company and the securities to be offered. The usual prospectus is a fairly stylized document and there is a customary sequence for organizing the material.

In the typical first public offering, the items which are most difficult to respond to, and which require the most creative effort in preparation, deal with the description of the company's business, its properties, material trans-

actions between the company and the insiders and how the proceeds will be used. Other matters required to be disclosed in the prospectus deal with the details of the underwriting, the plan for distributing the securities, capitalization, pending legal proceedings, description of securities being registered, identification of directors and officers and their remuneration, options to purchase securities and principal holders of securities. There are also detailed requirements concerning financial statements and financial information concerning the company's product lines.

In Part II of the registration statement there is supplemental information of a more formal type which is not required to be given to each investor. Unlike the prospectus, Part II is prepared in item-and-answer form. One requirement which is sometimes troublesome calls for disclosure of recent sales of unregistered securities and a statement of the exemption relied upon. Counsel may discover that past issuances of securities violated the '33 Act. In some such cases, the result is that the company's financial statements must reflect a very large contingent liability under the '33 Act. If past violations have been too flagrant, the offering may have to be deferred. Part II also contains supplemental financial schedules, as well as a list of exhibits which are filed with the registration statement. Normally, the information in Part II is not seen by individual investors, although sophisticated analysts and financial services may make extensive use of it.

The SEC, which reviews the registration statement, has no authority to pass on the merits of a particular offering. The SEC has no general power to prohibit an offering because it considers the investment opportunity to be a poor risk. The sole thrust of the Federal statute is dis-

closure of relevant information. No matter how speculative the investment, no matter how poor the risk, the offering will comply with Federal law *if* all the required facts are disclosed. By contrast, many state securities or "blue sky" laws, which are applicable in the jurisdictions where the distribution takes place, do regulate the merits of the securities.

In preparing a prospectus, the applicable form is merely the beginning. The forms are quite general and apply to all types of businesses, securities and offerings except for a few industries or limited situations for which special forms have been prepared. In the course of administration over the years, the Commission has given specific content to the general disclosure requirements. It often requires disclosures on a number of points within the scope of the form, but not explicitly covered by the form itself. Furthermore, in addition to information that the form expressly requires, the company must add any information necessary to make the statements made not misleading.[3] Thus, the prospectus may not contain a half-truth — a statement which is literally true but misleading in context.

The Commission's views on many matters change from time to time. SEC practitioners, both legal and accounting, constantly exchange news of what the Commission is currently requiring as reflected in its letters of comments. The SEC has also promulgated a set of official "guides" relating to the preparation and filing of registration statements.[4] These, as well as the applicable registration form, should be reviewed in detail as each new filing is prepared.

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3. SEC Rule 408, 17 C.F.R. § 230.408 (1969).

4. SEC Securities Act Release No. 4936 (Dec. 9, 1968).

The Commission has also evolved certain principles of emphasis in highlighting disclosures of adverse facts. As stated, it cannot prohibit an offering from being made, but it can make the offering look highly unattractive. In particular, if there are sufficient adverse factors in an offering, these are required to be set forth in detail in the very beginning of the prospectus under a caption such as "Introductory Statement" or "Risk Factors of the Offering."[5] However, many new issues of going businesses do not require this treatment and counsel must make a judgment in each case. Some of the adverse factors which may be collected under such a heading include: lack of business history, adverse business experience, operating losses, dependence upon particular customers, suppliers and key personnel, lack of a market for the security offered, competitive factors, certain types of transactions with insiders, a low book value for the stock compared to the offering price, potential dilution which may result from the exercise of convertible securities, options or warrants, and a small investment by the promoters compared with the public investment.

To the same end, the SEC has required that boldface reference be made to certain adverse factors on the prospectus cover page. The cover page statements must cross reference disclosures within the prospectus on such matters as high risk factors, immediate equity dilution of the public's investment and various forms of underwriting compensation beyond the normal spread. To add to the brew, the Commission sometimes insists that certain factors be emphasized beyond what the attorneys working on the matter consider to be their true importance. A usual example is that prominent attention must be called to transactions between the company and

5. *Id.*

its management. Often matters of relative insignificance, in terms of amounts involved, are made to appear very important by the amount of space given and placement in the prospectus.

The prospectus is a somewhat schizophrenic document, having two purposes which often present conflicting pulls. On the one hand, it is a selling document. It is used by the principal underwriters to form the underwriting syndicate and a dealer group, and by the underwriters and dealers to sell the securities to the public. From this point of view, it is desirable to present the best possible image. On the other hand, the prospectus is a disclosure document, an insurance policy against liability. With the view toward protection against liability, there is a tendency to resolve all doubts against the company and to make things look as bleak as possible. In balancing the purposes, established underwriters and experienced counsel, guided at least in part by their knowledge of the SEC staff attitudes, traditionally lean to a very conservative presentation. They avoid glowing adjectives, subjective evaluations and predictions about the future. The prospectus is limited to provable statements of historic fact. The layman frequently complains that all the glamor and romance has been lost. "Why can't you tell them," he says, "that we have the most aggressive and imaginative management in the industry?" It takes considerable client education before an attorney can answer this question to his client's satisfaction.

The quarterback in preparing the registration statement is normally the attorney for the company. He is principally responsible for preparing the non-financial parts of the registration statement. Drafts are circulated to all concerned. There are normally several major revisions before sending the job to the printer, and at least

a few more printed drafts before the final filing. Close cooperation is required among counsel for the company, the underwriters' counsel, the accountants and the printer. Unless each knows exactly what is expected of him by each of the others, additional delay, expense and irritation are inevitable.

Review by the SEC

After the registration statement is filed initially, the Commission reviews it to see that it appropriately responds to the applicable form and almost always finds some deficiencies which are communicated by its staff through the "deficiency letter" or "letter of comments." Amendments to the registration statement are then filed to meet the comments. When the deficiencies are cured, the SEC issues an order allowing the registration statement to become, to use the word of art, "effective." Only after the registration statement is effective may sales to the public take place.

If counsel, or the accountants, with respect to financial comments, feels that the staff's comments are inapposite or should not be met for some other reason, he will discuss them with the staff, usually by telephone but in person if the matter is sufficiently serious. The Commission's staff is generally reasonable in dealing with counsel's objections. However, as a practical matter, an offering cannot usually come to market unless an accommodation has been reached on all comments. Therefore, the staff usually has the last word on when the company has adequately met the comments, even if they are not legally binding in the formal sense.

Pre-effective Offers

In the interval between the first filing with the Commission and the effective date, the so-called "waiting period," the company and the underwriters may distribute preliminary or "red herring" prospectuses. The term "red herring" derives from the legend required to be printed in red ink on the cover of any prospectus which is distributed before the effective date of the registration statement. The legend is to the effect that a registration statement has been filed but has not become effective, and the securities may not be sold nor may offers to buy be accepted prior to the effective date.

During the waiting period oral selling efforts are permitted but no written sales literature — that is, "free writing" — is permitted other than the red herring prospectus.[6] Tombstone advertisements, so-called because the very limited notice of the offering which is permitted is often presented in a form resembling a tombstone, are not considered selling literature and may be published during the waiting period, although it is much more common for them to be published after the effective date.[7] Through the use of a red herring prospectus or by making oral offers by telephone or otherwise, the underwriters may offer the security and may accept "indications of interest" from purchasers prior to the effective date. However, as indicated, no sales can be made during the waiting period.

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6. For SEC interpretations on permissible activities during the waiting period, as well as in the pre-filing and post-effective periods, see SEC Securities Act Release No. 5009 (Oct. 7, 1969); SEC Securities Act Release No. 4697 (May 28, 1964); SEC Securities Act Release No. 3844 (Oct. 8, 1957). Certain proposed new rules and rule changes relating to this subject generally are contained in SEC Securities Act Release No. 5010 (Oct. 7, 1969); Securities Exchange Act Release No. 8710 (Oct. 7, 1969).

7. SEC Rule 134, 17 C.F.R. § 230.134 (1969), regulates tombstone advertisements.

Ideally, the investor should have the final prospectus available on which to base his decision whether to buy the security. Often this is not the case. It is theoretically possible to avoid entirely the requirements for delivering a prospectus to a purchaser without violating the law. The requirements can be avoided if the completed transaction is consummated without using the mails or any means or instruments of interstate commerce for any step from initial offer to final payment by the purchaser. In the much more typical situation, the offer and acceptance is by telephone, and the buyer first receives the final prospectus in the mail with the confirmation of the sale. He is thereby informed, assuming that he reads the prospectus and can understand it, about what he has already purchased. However, the document arrives much too late to aid in his initial decision whether to buy the security. Indeed, one commentator has dubbed it a "retrospectus." In order to counteract this, the SEC has undertaken certain steps to insure that a final prospectus or a substantially final red herring will be sent in advance of the confirmation to those indicating an interest during the waiting period.[8]

The Underwriting Agreement

The company often signs a "letter of intent" with its managing underwriter once the selection of the underwriter has been made. If used, the letter outlines the proposed terms of the offering and the underwriting compensation. However, it expressly states that it is not intended to bind either party, with the possible exception of a binding provision dealing with payment of expenses if one party abandons the transaction.

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8. SEC Securities Act Release No. 5010 (Oct. 7, 1969); SEC Securities Act Release No. 4968 (Apr. 24, 1969).

In a "firm commitment" underwriting agreement, the underwriters agree that they will purchase the shares being offered for the purpose of resale to the public. The underwriters must pay for and hold the shares for their own account if they are not successful in finding public purchasers. This form of underwriting is almost always used by the larger underwriters, and provides the greater assurance of raising the desired funds. In the other common type of underwriting arrangement, the underwriters agree to use their "best efforts" to sell the issue as the company's agent. To the extent that purchasers cannot be found, the issue is not sold. Some best efforts agreements provide that no shares will be sold unless buyers can be found for all, while others set a lower minimum such as 50 percent.

In either form of underwriting, the underwriters' obligations are usually subject to many conditions, various "outs" (*e.g.*, the right not to close in the event of certain specified adverse developments prior to the closing date) and compliance by the company with its numerous representations and warranties. The underwriters also condition their obligations upon the receipt of certain opinions of counsel and representations, sometimes called a "cold comfort letter," from the company's auditors.

The binding underwriting agreement is not normally signed until within 24 hours of the expected effective date of the registration statement — often on the morning of effectiveness. Thus, throughout the process of preparing the registration statement and during the waiting period, the company has incurred very substantial expenses with no assurance that the offering will take place. Once preparation of the registration statement has begun, however, reputable underwriters rarely refuse to complete the offering, although this can occur with some frequency,

especially for small and highly speculative offerings, if there is a sharp market drop during the waiting period. However, as indicated above, the underwriters must price the offering and organize the underwriting syndicate in relationship to market conditions prevailing at the time of the offering. Thus, if market conditions have worsened materially after the letter of intent stage, the issue must either come to the market at a price below that originally contemplated, or it must be postponed until conditions improve. On the other hand, sharply improved market conditions may result in a higher offering price than the parties originally anticipated.

Final settlement with the underwriters usually takes place seven to ten days after the registration statement has become effective, so as to allow the underwriters time to obtain the funds from their customers. At that time, the company receives the proceeds of the sale, net of the underwriting compensation.

Appendix C

[Excerpts from
GUIDES FOR PREPARATION AND FILING
OF
REGISTRATION STATEMENTS,
Securities Act of 1933 Release No. 4936, as amended.]

GENERAL PROVISIONS

1. Pre-filing Conferences with Registrants.

The Commission has a long established policy of holding its staff available for conferences with prospective registrants or their representatives in advance of filing a registration statement. These conferences may be held for the purpose of discussing generally the problems confronting a registrant in effecting registration or to resolve specific problems of an unusual nature which are sometimes presented by involved or complicated financial transactions.

Occasionally a registrant will request a pre-filing review of a registration statement, but such a review has been refused since it would delay the examination of material which has already been filed and would favor certain issuers at the expense of others. Registrants or their representatives also occasionally request the staff to draft a paragraph or other statement which will comply with some requirement or request for disclosure. The staff cannot undertake to prepare material for filing but limits itself to stating the kind of disclosures required, leaving the actual drafting to the registrant and its representatives.

2. Letter of Comment.

Letters of comment are sent out in most cases as a means of informing registrants of the respects in which a

registration statement is deemed not to meet the disclosure and other requirements of the Act and the forms and regulations thereunder. A letter of comment may not be sent out, however, where the circumstances are such that an investigatory or stop order proceeding is deemed more appropriate.

. . . .

5. Preparation of Prospectuses.

In order to make prospectuses more readable and understandable, and therefore more useful, registrants should limit their length and complexity by careful organization of the material, appropriate arrangement and subordination of information, use of tables and the avoidance of prolix or technical language and unnecessary detail. In this connection, attention is directed to Rule 460(f).

Material on the cover page should be as brief as possible with an appropriate cross reference to more complete information elsewhere in the prospectus which also should be used in lieu of explanatory notes on the cover page. Generally the cover page should be presented in accordance with the following guidelines except where special circumstances warrant additional disclosure.

a. Name of the issuer;

b. Description and amount of securities offered including, for example, appropriate disclosure of redemption and conversion features of debt securities;

c. The statement required by Rule 425;

d. The table showing the per unit and total offering price to the public, underwriting discounts and commissions and proceeds to the registrant or other persons;

Note: A separate section should be included in the body of the prospectus explaining the details of the compensation and any other benefits accruing to the underwriters including the aggregate cash payments made to the underwriters in connection with the offering such as expenses, finders' fees and investment counseling fees. All that is required on the cover page is a cross-reference to this section for an explanation of the underwriters compensation. Where an underwriter has received an over-allotment option, maximum-minimum information should be presented in the price table based on the purchase of all or none of the shares subject to the option. The terms of the option should be described in connection with the other compensation to underwriters rather than on the cover page.

e. The name of the underwriter or underwriters;

f. The date of the prospectus;

g. If applicable, a brief identification of the material risks involved in the purchase of the securities with a cross-reference to further discussion in the body of the prospectus; and

Note: If there has been no previous market for the company's securities, this should be stated in connection with the identification of risks. While no explanation need be given on the cover page as to the method of determining the offering price, there should be appropriate cross reference to further discussion in the prospectus.

h. Any material required by the laws of any state in which the securities are to be offered.

Note to Guide 5: Where an offering is not underwritten, or is underwritten on a best efforts basis or where

there is an exchange offer or rights offering the disclosures should be modified accordingly but every effort should be made to retain the brevity of the disclosure.

Stock phrases such as "There can be no assurance that the registrant will succeed in developing a commercial market for its product" or "A substantial number of companies that are engaged in the same business as the registrant have greater financial resources, experience and are better known to the public than registrant" or "In the opinion of management the unfavorable determination of any pending litigation would have no material effect on the business or financial condition of the company", *may not* provide meaningful disclosure unless accompanied by a brief explanation of the basis for such statements or the effect such conditions may have on the business of the registrant.

. . . .

6. Introductory Statements.

Where appropriate to a clear understanding by investors, there should be set forth immediately following the cover page of the prospectus under an appropriate caption a carefully organized series of short, concise paragraphs, under subcaptions where appropriate, summarizing the principal factors which make the offering one of high risk or speculative. These factors may be due to such matters as an absence of an operating history of the registrant, an absence of profitable operations in recent periods, the financial condition of the registrant, or the nature of the business in which the registrant is engaged or proposes to engage. In this connection, see In the Matter of Universal Camera Corporation, 19 S.E.C.

648 (1945) and In the Matter of Doman Helicopter, Inc., 41 S.E.C. 431 (1963).

Appendix D

[Excerpts from Wheat* & Blackstone,* GUIDEPOSTS FOR A FIRST PUBLIC OFFERING, 15 BUSINESS LAWYER 539, 560-62 (1960).]

As a by-product of the ever increasing tide of public securities issues, more and more lawyers face the tedious and complex task of preparing a registration statement under the Federal Securities Act. Not the least of the lawyer's problems may be encountered in advising an inexperienced client as to why this mysterious process takes so long, why valuable company officers should be required to spend so much time answering apparently endless questions, and what the total cost is likely to be. Not infrequently, the company lawyer is expected to furnish aid and comfort to his client in negotiations with a firm of investment bankers whose expertise and accumulated experience he cannot hope to match.

The purpose of this article is to touch upon a few points of practice in this somewhat specialized field of finance which lie almost wholly outside the law and the case books — although they are by no means new to the pages of *The Business Lawyer*.[1]

The discussion will center about a young and prosperous company named Plastic Products Co.[2] (later changed

*Members of the California Bar. [Mr. Wheat was a member of the Securities and Exchange Commission from 1964 through 1969.]

1. See, *e.g.*, Weisbrod, *Regulatory Aspects of Financing*, 14 Bus. Law. 910 (July, 1959); Glavin and Purcell, *Securities Offerings and Regulation A – Requirements and Risks*, 13 Bus. Law. 303 (April, 1958).

2. The names used herein are fictional and any resemblance to actual persons, firms or corporations of the same or similar names is purely coincidental.

to "Plastron, Inc." for reasons which will appear) which explores the possibility of a public stock offering, negotiates with an investment banking firm and ultimately proceeds with the preparation and filing of a registration statement.

. . . .

At the very outset of the proceedings, the company's officers should be warned not to issue publicity releases on the company and not to make statements for publication concerning the company's future plans and prospects without advance consultation with counsel. Any unusual publicity in advance of a proposed offering may be regarded by the SEC as an effort to condition the market for the company's securities by an illegal means (i.e., by means other than the statutory prospectus) and may result in an SEC-imposed delay in the offering.

* * *

After receiving the various items of information and documents produced for him by company officials, Mr. Jones has prepared a rough draft of the prospectus. With a certain pride of authorship, he gives a copy to Mr. Fisher who, after glancing through it, almost explodes:

"There's No Life In This Thing, Mr. Jones. How Can We Sell Stock With A Prospectus Like This?"

Mr. Fisher's question has been asked a thousand times before. It is up to Mr. Jones to explain that a prospectus is not intended to "sell" the company's stock in the same terms that Madison Avenue uses to sell the company's products. Instead, its prime function is to inform the potential investor of the risks inherent in ownership of the business. The prospectus cannot be expected to mirror Mr. Fisher's shining faith in the company's future — a

projection of the company's earnings for the next five years would be out of the question. Similarly, it cannot reflect the confidence of management that a new product (still in the research stage) will revolutionize the industry. Generally speaking, statements in the prospectus which are designed to make the company look good or to overcome the effect of disclosures of unfavorable factors will cause the most agony when the deficiency letter is received from the SEC.

Mr. Fisher listens carefully as his lawyer outlines the civil liabilities which persons signing the registration statement may incur under Section 11 of the Securities Act in the event there should be a misstatement or omission of a material fact. He takes comfort in the fact that prospectuses published by competitors are likewise devoid of glamour. He is advised that the prospectus should be regarded as a form of insurance policy written with great care to protect Mr. Fisher, his fellow directors and the company against unexpected (and hitherto non-existent) liabilities.

With this explanation, Mr. Fisher finds it easier to accept the over-all "negative" approach of the prospectus. However, he still questions the necessity for certain disclosures contained in Mr. Jones' draft.

Emphasis on Risks to the Investor: Mr. Jones has decided that it is not necessary for the cover page of the prospectus to carry a legend labeling the offering as a "speculation," which is often done for an unseasoned company. However, he is of the opinion that there are sufficient risks to the investor in Plastron, Inc. that they should be clearly identified at the outset (although Form S-1 does not specifically so require). In an "Introductory Statement" he has called attention to the organization of the company within the last five years, the recent loss of

a major customer for an important product, the acquisition by selling stockholders of their shares at nominal cost, and the immediate dilution to the new investor of his investment from a book value point of view. The volunteering of such an "Introductory Statement" will perhaps avoid an elaborate "deficiency" suggestion from the SEC staff as to introductory disclosures they deem necessary in order for the prospectus as a whole not to be misleading. Mr. Jones is aware of the staff's view that various unfavorable facts should not be scattered through the prospectus. If, in the context of the industry, the company presents unusual risks to the investor, a disclosure of such risks in the forepart of the prospectus is in order.

Discussion of Unfavorable Business Trends and Competition: Information appears in the section entitled "History and Business" showing that the backlog of orders as of December 31, 1959, was smaller than the backlog as of December 31, 1958. In addition, it is disclosed that the backlog of defense orders is proportionately larger than it was the previous year. It is stated that the profit margin on its defense business is higher than on commercial business, that profits from defense business are subject to renegotiation, and that defense contracts are subject to cancellation at the convenience of the government. Mr. Fisher reluctantly concedes that such facts have a material bearing on the profit potential of the company and should therefore be disclosed to investors.

Under the caption "Competition" there is a statement that the company's major competitors have much greater financial and other resources for research and development than has the company. To counter this, Mr. Fisher wants to describe his company as the "leader" in the field of plastic hardware, but in the absence of reliable sta-

tistics as to comparative dollar sales of competitors in this field, Mr. Jones does not believe it wise to engage in such self-congratulation.

Disclosures Concerning Management: No officer or director other than Mr. Fisher received compensation in excess of $30,000 in 1959, but it must be disclosed that Mr. Fisher's salary and bonuses for 1959 totaled $42,500 and that an aggregate remuneration of $112,800 was paid during 1959 to all directors and officers as a group. The terms of Mr. Fisher's five year employment contract expiring in 1964 must also be revealed, much to Mr. Fisher's annoyance.

Disclosure is made as to restricted stock options granted to Mr. Fisher, his associates and three other key employees in September, 1959, at option prices substantially below the offering price to the public.

It is stated that Mr. Fisher and his two associates took the initiative in organizing the company and that Mr. Fisher received half of his stock for promotional services, the balance of the shares issued to the organizers having been purchased by them for 10 cents a share (adjusted for the 100 for 1 stock split). (Such information is required by instructions to Item 11 of Form S-1 in view of the organization of the company within five years.) Information is also given concerning the terms of the lease by the company from Mr. Fisher of its principal factory building, including the annual rental and the original cost of the property to the lessor.

• • •

It comes almost as a surprise to Mr. Fisher that the registration statement is effective on schedule. At the closing conference on Monday morning one week later the company and the selling stockholders receive their

checks and Mr. Fisher suggests to his associates that they join him for a cup of coffee before going back to the plant. Mr. Jones' response is purely instinctive: "Did he say *coffee*? . . ."